

COMMONWEALTH INDEMNITY

3.1 The submarine contract required ASC to obtain, at the Commonwealth's cost, insurance cover over its marine builder's risks and risks in respect of public liability, property damage, and contract work policy. In 1991, after negotiation and litigation, the contract was amended to incorporate indemnities with terms similar to the commercial insurance covering the period between launch and acceptance of all *Collins*' successors.

3.2 In 1994 it became apparent that delays in the delivery schedule would cost the Commonwealth an additional \$18.5 million for insurance over Defence's original estimate. Defence advised the ANAO that the change from commercial insurance indemnities resulted in a price reduction of \$21.7 million (December 1994 prices), representing a pro rata refund of the deposit premiums already paid and the balance of the insurance premiums which would have been required if the insurance had been retained.(see Fig. 1)¹

3.3 A later Defence review assessed that the delay with submarine 01 (*Collins*) and the revised schedule for the other submarines would result in additional insurance costs, from October 1994 to the end of the project, of \$36.843 million.²

3.4 The Project Office recommended to Defence that the insurance be cancelled and replaced by a Commonwealth indemnity. The remaining insurance was replaced by financially uncapped Commonwealth indemnities put into effect on 1 October 1994 covering the construction, launch and acceptance of each submarine.³

3.5 The Audit Report stated that Defence's decision to grant the indemnity was not based on an in-depth analysis of the risks inherent in the construction program. Defence's risk

1 *Audit Report No. 34, 1997-98*, pp. 29, 30-1.

2 *Audit Report No. 34, 1997-98*, p. 29.

3 *Audit Report No. 34, 1997-98*, pp. xviii, 27-9.

analysis was completed **after** the indemnity was granted and was heavily qualified by the author who stated that the resource constraints prevented both a qualitative and quantitative analysis and that the risk analysis had been a desktop assessment based on the experience and judgement of project staff.⁴

3.6 Given the potentially very substantial exposure being undertaken by the Commonwealth, the ANAO considered that the risks should have been assessed prior to the agreement by a risk management expert with specialist qualifications and experience in statistical risk analysis and marine builder's risks and questioned whether the Project Office had applied sufficient resources to the risk assessment.⁵

Fig. 1

**INDEMNITY CLAIMS AGAINST NEW SUBMARINE CONTRACT
C218269**

The actual amounts paid out by the New Submarine Project, from approved project funds, under the indemnity scheme, together with Survey fees, follows:

	Physical Damage	Survey fees
1994/1995	\$254,185.00	\$ 6,022.00
1995/1996	\$ Nil	\$13,098.00
1996/1997	\$ 19,984.00	\$10,248.00
1997/1998	\$ Nil	\$ 8,005.00
	<hr/> \$274,169.00	<hr/> \$37,373.00

Total cost to the Commonwealth to date is \$311,542.

The actual reduction in the Contract Price resulting from the cancellation of the insurance policies was \$21.7 million (December 1994 prices).

The estimated saving at May 1999 was \$55.6 million.⁶

4 *Audit Report No. 34, 1997-98*, pp. 33, 36.

5 *Audit Report No. 34, 1997-98*, p. 33.

6 DAO, Correspondence, 10 May 1999, p. 1.

3.7 The Audit Report stated that Defence carried substantial risks through the indemnity granted to ASC and its contractors, but Defence maintained that the nature of the risk was well understood and that further delays had resulted in Defence estimates of savings in insurance premiums in excess of \$50 million.⁷

Committee comments

3.8 The JCPAA agrees with ANAO that the Commonwealth carried substantial risks through the indemnity granted to ASC and its subcontractors, particularly as it took on the indemnity in the later, higher-risk, part of the project.

3.9 The JCPAA considers that the advantage of cancelling insurance cannot be stated simply as the amount of the premiums saved. Cancelling insurance and granting an indemnity transferred considerable risk to the Commonwealth.

3.10 The Committee considers that the change from commercial insurance to Commonwealth indemnity should have been made only after a thorough assessment by Defence of the risks transferred to the Commonwealth as a result of doing so.

\$2.4 million payment for insurance services

3.11 As referred to above, when it became apparent in 1994 that slippage in the submarine delivery schedule would result in increased insurance costs for the Commonwealth, commercial insurance was replaced by a Commonwealth indemnity. The deposit premiums that Defence had paid for ASC's insurance included commissions to ASC's insurance broker. When the indemnity was granted and the insurance was cancelled, Defence became due for a refund of prepaid premiums.⁸

7 *Audit Report No. 34, 1997-98*, pp. 30, 31, 36.

8 *Audit Report No. 34, 1997-98*, p. 35.

3.12 ASC's insurance broker was concerned that the indemnity left the broker without broker's commissions from the insurers. The broker had expected to receive these commissions for some years to come. However, Defence's insurance adviser advised that the broker's loss of commission on terminated insurance was 'just part of business'.⁹

3.13 Ultimately, ASC's broker retained an amount of \$2.4 million of the insurers' refund of prepaid premiums due to Defence, in return for future services the broker might provide to ASC to gain the maximum benefit from the indemnity provided by the Commonwealth.¹⁰

3.14 The Committee sought to clarify why the \$2.4 million was diverted to the insurance broker and why Defence held incomplete records in relation to the matter.¹¹

3.15 Defence responded that the \$2.4 million was paid to the broker for management services to which ASC was entitled under the contract:

*... by [terminating the commercial insurance], we did not terminate [ASC's] need or [ASC's] reasonable entitlement to the same level of advice on what was now a Commonwealth indemnity ...*¹²

3.16 The Committee noted that the insurance rebate due to Defence was \$2.4 million and asked Defence why it agreed to pay the same amount to the broker for management services against the advice of Defence's insurance adviser.¹³

3.17 Defence replied that its insurance adviser was not asked to advise on that particular issue and that he was not aware of the contract provisions under which the arrangements were made.¹⁴

9 *Audit Report No. 34, 1997-98*, p. 35.

10 *Audit Report No. 34, 1997-98*, p. 35.

11 *Transcript, 29 April 1998*, p. PA 67.

12 Mr John Hyman, Commercial Director, Undersea Warfare Systems, Defence, *Transcript, 29 April 1998*, pp. PA 67, 69.

13 *Transcript, 29 April 1998*, p. PA 67.

14 Mr John Hyman, Commercial Director, Undersea Warfare Systems, Defence, *Transcript, 29 April 1998*, p. PA 67.

*Our general contracts advisers were the project's staff who, if they had felt there was a need for clarification, would have referred the matter for expert advice. But they felt that it was not necessary.*¹⁵

3.18 In response to the Committee's request for its comment on the matter, ANAO stated that it stood by its statements in the Audit Report.¹⁶

3.19 The Committee drew the ANAO's attention to the following quote from the Audit Report and sought comment from the ANAO:

*In the absence of complete records, the dimensions of the arrangements are unclear, as indeed are the benefits to the Commonwealth On the face of it ... raising the question of the legal authority for such a payment.*¹⁷

3.20 ANAO responded that:

*Preferably, from the Commonwealth's point of view, we would expect such transactions to be separated; we would not have those sorts of set-off arrangements for accountability purposes. The answer to your question is that we were not able to get sufficient evidence to clarify the matter to the satisfaction of the committee.*¹⁸

3.21 The Committee requested further written clarification from Defence in relation to the issue of the payment of \$2.4 million.

3.22 Defence supplied documents which indicated that the Project Office regarded only the brokerage earned up to termination of commercial insurance as being the broker's entitlement, expected any brokerage on premiums after that date would be returned, and discussed the possibility of instituting proceedings against ASC and the broker to recover all of the brokerage assessed as being unearned.

15 Mr John Hyman, Commercial Director, Undersea Warfare Systems, Defence, *Transcript, 29 April 1998*, pp. PA 69-70.

16 Mr Tony Minchin, Executive Director, ANAO, *Transcript, 29 April 1998*, p. PA 70.

17 *Transcript, 29 April 1998*, p. PA 70.

18 Auditor-General, *Transcript, 29 April 1998*, p. PA 70.

3.23 A document supplied by Defence advised that the claim for 'expectation brokerage' had been withdrawn by the broker and that the broker would be paid a lump-sum fee of \$2.4 million for insurance services post 1 October 1994.

Committee comments

3.24 ASC's broker initially retained \$3.7 million in a disputed calculation of expected brokerage from the date of insurance cancellation to the delivery of submarine 06.

3.25 The Project Office, and the Commonwealth's insurance adviser, were firmly of the view that the broker's entitlement was only the brokerage earned up to 1 October 1994 and expected any brokerage on premiums after that date to be returned in the same way as premiums. Indeed, the Project Office raised the possibility of legal action being taken to recover all of the brokerage.

3.26 Ultimately, the broker retained \$2.4 million, ostensibly for 'insurance services' after 1 October 1994.

3.27 The Committee has received conflicting explanations and documentation from Defence concerning the retention of \$2.4 million by ASC's insurance broker following the cancellation of commercial insurance:

- On **10 July 1995** the Project Office agreed with ASC and the broker that the broker would **withdraw his claim for expectation brokerage**. It was further agreed that the broker would be paid **\$2.4 million for insurance services to ASC** post 1 October and that the broker would prepare a statement with relevant schedules to support the fee of \$2.4 million.
- On **10 August 1995**, the broker stated in correspondence to ASC that **'We have agreed to a brokerage fee of:- \$2.4 million'**.
- On 2 February 1998 the Secretary of Defence told the ANAO that the **\$2.4 million payment to ASC's insurance brokers was due under the contract** and had been negotiated down from an original claim of \$3.7 million.
- On 25 May 1998 Defence stated to the Committee that **'The \$2.4 million represented a payment for insurance services to ASC** post 1 October

1994 which Defence had agreed to fund under the original contract’.

3.28 The Committee makes the following observations:

- Defence stated in its submission that the Commonwealth was obliged under the contract to fund insurance services required by the ASC to minimise its exposure to risk.¹⁹ However, the Project Office’s insurance adviser saw no need for the payment on commercial grounds. In the absence of any legal advice being sought at the time, the ANAO has queried the legal authority for such a payment.
- The draft contract, a three-page document of breathtaking insubstantiality, was the only document which Defence could supply to the Committee. The document is headed ‘Contract for Insurance Services’, but no insurance services are specified in the contract.
- The Committee notes that the Commonwealth’s insurance adviser expressed his surprise to Defence that the ASC’s broker was to be paid a lump sum for services and wondered what role Defence anticipated the broker performing during this period. The insurance adviser offered on three occasions to review the relevant schedule supporting the broker’s claim for the \$2.4 million fee but was eventually told by Defence that the insurance matters were proceeding to Defence’s and ASC’s satisfaction.
- The Audit Report noted that it would have been appropriate to pay for continuing services as they were performed instead of in a lump sum. The Committee notes that Defence paid its own advising firm on submarine indemnity matters \$25 700 per year plus an hourly fee for claims management.²⁰
- Defence stated that the arrangements regarding the amount of \$2.4 million were examined by its Financial Cost Investigators but the ANAO found no evidence of such examination, other than evidence that a Financial Cost Investigator in Adelaide had a copy of the draft contract.

19 Defence, Submission No. 1, p. 11.

20 *Audit Report No. 34, 1997-98*, p. 35.

- Defence has been unable to supply evidence of any insurance services provided to ASC post 1 October 1994 under the contract.

3.29 Defence argued that the negotiated settlement of \$2.4 million for insurance services was commercially sound and that the replacement of commercial insurance with a Commonwealth indemnity could not otherwise have been effected.

3.30 The Committee considers that in order to protect the Commonwealth's interests, Defence should have sought legal advice on whether it had any obligation to ASC's broker for loss of future commission or any other reason or whether it could have declined to make such a payment on the grounds of normal insurance industry practice.

3.31 It would also have been prudent for Defence to have sought a copy of the final contract for 'insurance services'.

3.32 Defence told the Committee that the retention of the \$2.4 million by ASC's broker rather than recovery and payment was a 'streamlined' process which resulted in the same outcome. The Committee considers it unacceptable, in accountability terms, for moneys to be retained in the way they were in this matter and for transactions not to be clearly separated.

3.33 The absence of a complete audit trail in relation to any payment deserves censure. It is the view of the Committee that in this particular matter, such an absence serves only to underline the irregular nature of the arrangement agreed to by the Commonwealth.

3.34 From the Committee's reading of the available documents, it would be possible to form the view that the 'payment' of \$2.4 million to ASC's broker for 'insurance services' was a contrived arrangement to avoid taking legal action, to meet the broker's interpretation of ASC's assurance that he would not be disadvantaged by the cancellation of insurance and to appear to meet the Commonwealth's requirement to not pay for work not performed.

3.35 The Committee notes that Defence was unable to supply the ANAO with any evidence of insurance services being provided to ASC post 1 October 1994 under the arrangement.

3.36 The Committee considers that the actions of Defence personnel in this matter were, at the very least, clumsy and irresponsible. In view of the fact that the Committee has found Defence unwilling to pursue the matter and Defence's own statements on the matter conflicting, it makes the following recommendation:

3.37 **Recommendation 1**

The Committee recommends that the Minister for Defence direct the Secretary of the Department of Defence to institute an investigation to establish: the appropriateness or otherwise of the \$2.4 million payment to the Australian Submarine Corporation's broker; whether Commonwealth monies may have been misdirected; and why a full audit trail could not be produced.

3.38 **Recommendation 2**

The Committee recommends that where the Department of Defence settles a commercial dispute, the settlement process be openly and properly documented.