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AUDIT

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1997-98**

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JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

Friday, 14 May 1999

Members: Mr Charles (*Chair*), Mr Cox (*Deputy Chair*), Senators Coonan, Faulkner, Gibson, Hogg, Murray and Watson and Mr Andrews, Mr Brough, Mr Georgiou, Ms Gillard, Mr Griffin, Ms Plibersek, Mr Somlyay and Mr St Clair

Senators and members in attendance: Senator Gibson and Mr Charles, Mr Georgiou and Mr Griffin

Terms of reference for the inquiry:

Review of Auditor-General's reports fourth quarter 1997-98

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Committee met at 10.45 a.m.

CHAIR—I welcome you to today's public hearing which is the fourth in the series of quarterly hearings to examine reports tabled by the Auditor-General in the financial year 1997-98. This morning we will be taking evidence on two audit reports, namely Audit report No. 43 1997-98, *Life-cycle Costing in the Department of Defence* and Audit report No. 44 1997-98, *The Australian Diplomatic Communications Network—Project Management*. We will be running the sessions as a round table format which means that all relevant participants will be present to hear what others are saying about the Auditor-General's reports.

I must ask participants strictly to observe a number of procedural rules. First, only members of the committee can put questions to witnesses if this hearing is to constitute formal proceedings of the parliament and attract parliamentary privilege. If other participants wish to raise issues through discussion, I ask them to direct their comments to me and the committee will decide if it wishes to pursue the matter. It will not be possible for participants directly to respond to each other. Second, in keeping with the length of the program, statements and comments by witnesses should please be kept as brief and succinct as possible.

Third, I remind witnesses that the hearings today are legal proceedings of the parliament and warrant the same respect as proceedings of the House itself. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament. The evidence given today will be recorded by Hansard and will attract parliamentary privilege.

Finally, I refer any members of the press who are present to a committee statement about the broadcasting of proceedings. In particular, I draw the media's attention to the need to report fairly and accurately proceedings of committees. Copies of the committee's statement are available from secretariat staff. The audit report being considered in this first session is Audit report No. 43 1997-98, *Life-cycle Costing in the Department of Defence*.

[10.48 a.m.]

GAIREY, Mr Mark Christopher, Director General, Acquisition Planning, Department of Defence

GRANDIN, Mr Brian Trevelyn, Director, Business Practices, Defence Estate, Department of Defence

KELLY, Brigadier Garry, Director General, Projects Delivery, Defence Estate, Department of Defence

MERCHANT, Mr Stephen John, Director General, Investment Analysis and Programming, Australian Defence Headquarters, Department of Defence

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McPHEE, Mr Ian, Deputy Auditor-General, Australian National Audit Office

MINCHIN, Mr Antony St John, Executive Director, Australian National Audit Office

SMITH, Mr Graham John, former audit manager of Australian National Audit Office, now at Environment and Heritage

CHAIR—I welcome representatives from the Australian National Audit Office and representatives from the Department of Defence to the first session of today's hearing. We have convened the public hearing to examine the main issues raised in the Auditor-General's report No. 43, *Life-cycle Costing to the Department of Defence*. The JCPAA will take evidence today on issues relating to the implementation of life-cycle costing at Defence. The Auditor-General's views have been set out in the report and it has had the initial responses from the audited agency. However, the committee is interested to learn if any action has already been taken or is planned to address the issues raised in the Auditor-General's report. Major General Mueller, do you have a brief opening statement that you would like to make?

Major Gen. Mueller—I might make a few opening remarks. In doing so, I will start from the point of view that the assumption is that the committee understands in conceptual terms what life-cycle costing is about. Perhaps it would be worth while if I make the observation that I tend to draw on the work of two recognised experts in this area. One is a fellow called Benjamin Blanchard, who works in the United States and is the author of a book called *Logistics Engineering and Management*. It is a book that is widely used in tertiary institutions in Australia, North America, Europe and elsewhere. The other widely recognised expert is James V. Jones who works in California. The views of those two individuals have over a period of time shaped my views on life-cycle costing significantly.

With particular reference to the ANAO audit, I think it is reasonable to make the observation that, prior to its publication, within Defence we had already initiated a number of activities which would be consistent with the implementation of those recommendations. In particular, in my organisation, Support Command Australia, which was formed on 1 July 1997 and represented the amalgamation of the hitherto quite separate Navy, Army and Air Force logistics systems, we established an organisation called the Joint Logistics Systems Agency. One of the roles of that particular agency is to move Defence towards common logistic business processes and to progressively federate, if not integrate, its logistic information systems where it is cost effective to do so.

One of the activities that we have initiated is what we call a 'Through-life support disciplines project'. It is intended to develop and to promulgate common policy but, frankly—more importantly—common procedures and techniques for a range of through-life support disciplines, which include life-cycle costing analysis, which is the bottom line of other through-life support disciplines which are very important at the front end of the life cycle. I am referring, I suppose, to somewhat archaic disciplines like systems engineering and integrated logistics support, level of repair analysis and so on.

I will perhaps just make a couple of observations, though, on life-cycle costing itself. I think there needs to be a recognition that decisions that determine the greater part of life-cycle costs are made during the conception and acquisition stage of the life cycle. So once the platform or the system enters service, the decisions that are actually driving your life-cycle costs have already been made. If you are looking probably at about a 10-year conception and acquisition stage and then an in-service stage of the order of 20 to 30 years which is completed with retirement and disposal, at the front end of that life cycle you are trying to make estimates on life-cycle costs over a 40-year period.

Blanchard has all sorts of elegant methodologies which are quite convincing if they are divorced from the real world. I have had the opportunity to talk to Jones, and Jones has always said to me, 'Beware of a couple of things. Life-cycle costing for major projects is always incomplete and it is always inaccurate, but it does a couple of important things for you. It will enable you to make informed judgments on major alternatives.' In other words, if you are looking at wide area surveillance, he said the life-cycle costing, for example, of a satellite system as opposed to an aircraft system will be of an order such that you can make with some confidence a life-cycle cost judgment.

He also said that it will enable you to identify the key cost drivers, and when you are looking at alternative solutions—in other words, for example, different aerial platforms—you are able to identify where the real cost drivers are, and during the conception and acquisition stage it enables you to focus on those and, hopefully, drive down your life-cycle cost to a minimum. The other thing, of course, that comes out of that—and this is recognised in the ANAO report—is that you apply life-cycle costing to a degree which is consistent with the benefits compared to the costs of doing it, and major life-cycle costing can be very, very expensive.

CHAIR—Mr McPhee, do you have a brief opening statement?

Mr McPhee—Thank you, Chair. I have provided a copy of an opening statement which, if the committee is happy, could be tabled. It essentially goes to the audit summary. I will just make a couple of comments.

As indicated by Major General Mueller, life-cycle costing is Defence policy. The audit was very much directed to the implementation of their own policy within the agency, and the recommendations were designed really just to refine the implementation that they have already in place. Interestingly, we used Professor Blanchard as a consultant in the audit report, and we actually say that in paragraph 1.16 of the report.

CHAIR—Is it the wish of the committee that the opening statement be incorporated in the transcript of evidence? There being no objection, it is so ordered.

The document read as follows—

CHAIR—Major General Mueller, where do you see advantage in the use of lifetime costing later on in the life of the platform? Let us say the Collins is 20 years old: of what value is it to you to keep up dating life cycle costs?

Major Gen. Mueller—Life-cycle costing on balance is about estimating, if you like, forward costs. Obviously during the conception and acquisition stage that is what you are doing. If you are tracking life-cycle costs when a platform is in service, the first thing that you are aware of is trends in your life-cycle costs and you are able to identify what is driving those trends. Having identified what is driving those trends, you are then in a position to do something about it. If, for example, you are getting towards the end of the life cycle of a platform or system, on balance its reliability will start to deteriorate.

This should be obvious from two sets of data if you are able to comprehensively collect them: one is in your reliability engineering data and the other in trends in your life-cycle costs. Theoretically, you should be able to correlate the two. That then enables you, as I have previously mentioned, to focus on the driver of your cost increases, and that may then lead you, for example, to pursue investment in a modification if it can be determined to be cost effective.

Mr GEORGIU—You made a point that it is important to make an informed judgment on major alternatives.

Major Gen. Mueller—Yes.

Mr GEORGIU—What does that actually mean? Does it mean that there are instances where the life-cycle costs determine one option rather than another? If so, can you advise us where it has actually been used in this way here?

Major Gen. Mueller—I am not aware, intimately, of how life-cycle costing issues have been used previously to inform judgments on source selection. I do not work in the Defence Acquisition Organisation, and I might invite the DAO to do that. I go back, if I may, to James V. Jones who said to me, I can recall, on two separate occasions, ‘Never, ever make your source selection based on life-cycle cost estimates alone.’ He went back to his point that they are always flawed and they are always incomplete. He said they are one source of information which should be used to shape your judgment. On the other issue, perhaps DAO may wish to address that.

Mr Watters—The basis of source selection is not necessarily the cheapest price in the tender box. It is a multidimensional decision that involves consideration not only of the offer but whether it will meet the technological specification for Australian industry and the extent of that, the terms and conditions of the contract and life-cycle costing. Many other factors are taken into consideration in determining company A over company B in terms of the offers in the tender box. Life-cycle costing is a factor which we take into account, but it is one of many factors which we take into account.

We seek to do that by a standard contracting template called DEFPUR 101, which is basically the standard terms and conditions of contract, in that we generally require life-cycle costing. The quality of the data that we get from tenderers is not always reliable. We must

appreciate that at that stage in the process there are fairly strong commercial interests involved to understate life-cycle costs rather than perhaps give a realistic estimate.

I think one of the main difficulties we have in implementing life-cycle costing in the Defence Acquisition Organisation is not the policy; we think we have a handle on that. It is not the training; we think we have a handle on that. It is not the lack of encouragement of people to do life-cycle costing; it is, in fact, the quality of the data. We see three sources of data for life-cycle costing. It can come from the respondent—

Mr GEORGIU—Can I stop you there? I would like to go back to the original point—I think we are going to come to the data issue later. I am still unclear about this. My impression is that, while it is one of the considerations, it is never a significant consideration and the differences in life-cycle costings get washed out or minimised in decision making. That is a different point from, ‘No. You don’t make a decision on life cycle.’ I just want to know how significant it is as a factor in making choices. Are there instances where the life-cycle costs have been the determinative factor in choosing between one system and another system?

Mr Watters—I think the answer to that question is no. I think it has informed the decisions we have made, but I do not think it has been a deciding factor in any talks.

Mr GEORGIU—Can you talk a little more about that because I would like to understand it. I am not being critical, but I just want to understand how it fits in.

Mr Gairey—I might give some examples of the sorts of things that we are talking about. Given what has already been said about the unreliability of the data, what we often find we can do is look at the cost drivers or the likely cost drivers for the through-life costing of a particular system or offer. I will quote a couple of examples. In one recent evaluation process, one of the tenders was assessed as requiring twice the manpower through life compared with the other tenders on the table. That would clearly have a significant impact on the cost of acquiring that particular offer if we had done so. While that factor on its own did not become a significant driver in our final decision, it was yet one of the factors that was against selecting that particular offer.

Mr GEORGIU—Can I turn that around? If the bid that you chose had had twice the manpower over the life cycle, are you saying that that would not have dissuaded you from choosing that?

Mr Gairey—No. What I am saying is that, in looking at the balance of factors that led to our decision, one factor that led to the non-preferred source was the fact that, all other things being equal, they required much more manpower—hence, higher personnel costs and training costs through life—therefore, there was likely to be a much higher through-life cost.

Mr GEORGIU—I will just press this one more time. What would happen if what you liked had twice the manpower of what you did not like. Let us say you liked one and you chose it but it also had less manpower. If the situation had been reversed and the system that you liked, whatever it was, had had twice the manpower, would you have said, ‘Oops. No, we are going for the other one’? My questions sometimes get a bit obscure.

Mr Gairey—I understand. I come back to what my colleague said earlier. At the end of the day, what we are trying to do is make an overall value for money choice for the Commonwealth. What we are doing is looking at the whole raft of factors, of which potential life-cycle cost and life-cycle implications are but one.

Mr GEORGIU—So the answer is no. You would have gone for what you liked anyway.

Mr Gairey—It would depend on how close the decision was. I cannot be more specific than that, because each of these things has to be determined on the evidence available on the day.

Major Gen. Mueller—It may often become a question of cost versus capability. You have to trade one off against the other, and you may opt to take a system with higher life-cycle cost because of the capability that it offers.

Mr GEORGIU—So you feel better if you get your capability and it is backed up by that but, at the end of the day, you want what you want and life cycle is marginal.

Major Gen. Mueller—On other cases, I would suggest that you may trade off capability because, with the better solution, the life-cycle costs are just exorbitantly high. It is a matter of trade-off; it has to be a matter of judgment.

Mr GEORGIU—Can you give us an example? Is there is a case that you can think of where that second choice was made, where an option was foregone because the life-cycle costs were too high?

Mr Watters—I can recall occasions on which we have gone back to tenderers and asked them to justify what appear to be very high life-cycle costs in clarification processes, but I cannot recall a decision of the type you mention.

Senator GIBSON—In the ANAO report, there is reference to overseas practice on page 4 and 5, in both the UK and Germany. It says:

In Germany the armed forces consider life-cycle costs on an equal footing with other parameters such as operational and technical requirements and timeframe for acquisition.

It also says that in the UK there have been policy guidelines since 1974 but they have been implemented only in more recent years. Can any of you explain to the committee your knowledge of what happens in other countries—the UK, Germany, the US—in adopting life-cycle costs and helping decision making for platform decisions?

Major Gen. Mueller—Perhaps again I might refer that particular question to my colleagues from the Defence acquisition office. I might preface it with just one observation. Last year I had the opportunity to discuss with the Royal Air Force at some length their difficulties with their logistic information systems. I think I once mentioned to this committee that I suspect that their difficulties are about the same order as those of the

Australian Defence Force, and it is a universal problem in defence organisations right throughout the world.

One of the things they did point out to me was the difficulty they do have with life-cycle costing, especially for in-service platforms and systems, because of the difficulty of actually aggregating the data and getting ready access to it. That was particularly a problem with their engineering and maintenance information systems, which tended to be neither federated nor integrated. With regard to practice in source selection elsewhere in the world, I will invite, if I may, the DAO to speak on that.

Mr Watters—My experience with the Pentagon was that there was a group within the Pentagon that spent quite a bit of time scrubbing over project cost estimates before they were actually approved as part of the government process. There is a process under what is called the cost analysis improvement group. That did not relate just to through-life cost; the acquisition costs were also looked at by an independent group within the Pentagon. They have much more parametric data than we have in terms of estimating costs and life-cycle costs.

CHAIR—Much more what?

Mr Watters—Parametric data—in other words, data that they can build on from experience with existing platforms. We find that with replacement of a major aircraft, for example, the data that we have relates to a piece of technology that is perhaps 20- or 30-years-old. In the United States, you might have two or three current generation aircraft that can provide you with reasonably good data as to what a replacement for one of those might cost. So I think they are in a much more favourable position in terms of their databases and their access to them than we are in Australia. Once again this comes back to the reliability of the data that we are looking at.

Mr GEORGIU—Can I pursue the point about choice between options. I can understand wanting something but I am puzzled that there has not been a case where the preferred capability has not been counted by life-cycle costs. Why is that?

Mr McPhee—Generally, in an acquisition you set the criteria which are going to be used for the particular item. It may be that cost is given a rating or ranking of only 30 per cent of the overall decision. Often these days people use a model to weight the various factors and so cost might be multiplied out at only 30 per cent to give a score which adds into the other scores dealing with capability and quality of support, et cetera. So it is always an element within a decision to get to the value for money decision. You can probably look at cost and determine how much the cost would need to change to change the decision that you are about to make, but alone it is not a factor which will turn a decision.

Mr Smith—The audit points out in paragraph 4.8—admittedly only one example—where the tender assessment used a weighting of 1.2 per cent for the life-cycle cost contribution to that decision.

Mr GEORGIU—I have something else I want to pursue. I have become something of an aficionado of agreed in-principle recommendations. One of the recommendations which struck me as being reasonably straightforward is recommendation 2 on page xvi. It says:

. . . as part of the development of guidance . . . establish consistent definition of terms,

and then c):

. . . ensure that explicit information is provided to relevant Defence committees.

Defence's response was that b) and c) were agreed 'with qualification'. The qualification is:

The amount and type of LCC information presented to committees will vary according to the issues being considered and only pertinent information should be included.

What puzzles me about that response is that it is what one would have expected. Why is there particular sensitivity to explicit information? Why is there such sensitivity to what is required that you agree in principle and then say, 'We are going to give precisely what everybody else would have expected us to give'?

Major Gen. Mueller—I am not cognisant of what qualifications Defence may have had in mind. Are we referring to recommendation 2, paragraph 3.26?

Mr GEORGIU—Yes, point c.

Major Gen. Mueller—Bear in mind our own through-life support disciplines project, which really is complementary to and will provide support for three other major initiatives currently being conducted by Defence. One is a major business process, a re-engineering initiative by the Defence Acquisition Organisation. The second is a similar initiative by the Capability Development Division, which sits under the aegis of a capability management improvement team project which is being driven by the Defence executive. I do not have any difficulty with any of those recommendations and my view would be that we are pursuing them.

Mr GEORGIU—That is what prompted my question. The recommendations and qualifications seem to be perfectly consistent. I am just puzzled about why Defence wanted to throw in a qualification. Why is there such sensitivity? Point c is the most clear-cut. It says, 'explicit information is provided,' et cetera and Defence says that the qualification is that only pertinent information should be provided. Why is it not just agreed?

Major Gen. Mueller—I would assume that it would be only pertinent information in an explicit form.

Mr GEORGIU—One would assume that that is what it is asking for. What is their problem? What underlies that qualification? Somebody must have qualified it. Somebody must have said, 'No, we are not agreeing with this.' There must be a reason why there is only qualified agreement because it is not apparent on the face of what you are qualifying. Why is that a qualified agreement?

Major Gen. Mueller—As I said, I do not have any difficulty with the recommendations. I cannot throw any further light on that.

Mr GEORGIU—Can you understand why I am puzzled?

Major Gen. Mueller—You can be comfortable that the recommendations are being pursued.

Mr GEORGIU—Can you understand why I am puzzled?

Major Gen. Mueller—Certainly. As someone from Melbourne, many things about Canberra puzzle me.

Mr GEORGIU—We can take it that Defence actually agrees. Turning to the recommendation where there is substantive disagreement, can you give us a run down on the recommendation that is not agreed? Why do you feel that Defence should pursue it? Why are you not persuaded by their resistance to it, Mr McPhee?

Mr McPhee—The issue arising was in recognition of the significant total life-cycle costs. Generally speaking, if life-cycle costs are two to three times the acquisition costs, it is a very significant factor during the life of the asset. The recommendation was designed to suggest to Defence that they look at possibilities for getting tenderers as part of their contract performance to make a firm commitment at the contract stage regarding significant assertions made about life-cycle costs. That was where we were driving. The department felt that it could not agree with that, that the risks around the numbers were probably too high and that the Commonwealth would pay for it in terms of the risk premium that any provider would put on the costs of the acquisition. Certainly, we were trying to get to how to better control life-cycle costs and to tie down significant assertions made by providers.

Major Gen. Mueller—Again, I will refer this matter to DAO because I presume that it has significant implications for acquisition contracts and for through-life support contracts if, indeed, they are put in place concurrently with acquisition contracts.

Before I do so, I will make an observation. My chief aeronautical engineer points out to me repeatedly that every aircraft is made up of several million engineering judgments, none of which is infallible. We all need to remember that every time we get on an aeroplane. Those judgments, up-front, impact significantly on issues like reliability. Often those judgments are not translated into practice. To give you an example of what I mean, we may purchase a platform or a system which was designed and built overseas to meet the needs of a particular mission profile. When we bring it into service and operate it in the characteristics peculiar to the Australian environment, its reliability may not be what the original equipment manufacturer forecast because we tend to be working more often at the edge of its performance envelope.

CHAIR—Are you talking about tanks that we tried to operate in the Northern Territory without airconditioning?

Major Gen. Mueller—You could be talking about tanks, aircraft, ships or a range of things. It means that you find, for example, that your component replacement times may suffer as a result. Rather than replace a given component after a certain period of time, which was designed into the system, you find that, because of the circumstances in which we operate, you have to change it more often. Therefore, your life-cycle costs go up.

My view would be that, if you try to hold a contractor to his reliability forecast, you are forcing the risk onto him and he will charge accordingly. The aim of life-cycle cost analysis is to minimise life-cycle costs. The problem here is that we might end up paying a premium by endeavouring to force him to undertake a guarantee on reliability.

There are two techniques that I am aware of. One is called ‘mean time between failure guarantee contracts’ and another is called ‘RIW—reliability improvement warranty’. They have been tried in the United States and my advice is that they have not worked all that successfully for the reasons I have just outlined. I refer now to DAO.

Mr Watters—I can add a number of reasons. We find life-cycle costing a reliable indicator of relativities between offers that are in the tender box. They are less reliable as an indicator of what something might absolutely cost over a 25- or 30-year life, particularly when you are dealing with new technologies that are previously unused. The question of how to implement this is a very important one. If we do build this sort of guarantee into a contract then I expect the price of the goods we are purchasing is going to go up as a result, particularly if we start taking liquidated damages or some other punitive measure should the reliability not turn out as we expected when we bought the equipment.

The other thing I need to say is that reliability depends on how equipment is used. If I told a contractor that something has not met the reliability, I suspect we would immediately be into an argument about how the equipment was being used and whether that was envisaged at the time the contract was written, et cetera. There are a few issues related to that that make this a very difficult recommendation to implement.

The other thing the minister was keen to point out in his media release when he addressed the ANAO report was that this sort of process would add further to the high cost of tendering for Defence business that always is of concern to industry. His view was that the benefits that we get from this sort of clause in our contracts would not necessarily justify the sorts of costs that would be involved.

As to where we are headed with this, there are some examples where we have tried to link our contracts not to reliability but to availability, and that relates to some specific types of equipment. For example, the lead-in fighter aircraft, which are used in a very well defined regime of use, do have an availability clause in their contract. In other words, we have signed a contract for the original equipment, we have signed a contract for the support of that equipment through its life and we have linked an availability clause into that which does have damages attached to it if the contractor does not provide sufficiently reliable aircraft to meet our requirements. So there have been some quite specific examples where we have been able to move in the direction of this recommendation, although I do not believe that it is widely applicable.

CHAIR—How do you enforce that if the aircraft is 10 years old? You paid the contractor 10 years ago for the aircraft.

Mr Watters—We have paid him for the acquisition cost, but we have not paid him for the maintenance cost. So there is an ongoing cost. What we are increasingly doing with our closer working relationship with Support Command is signing, say, a five-year support contract at the same time we buy the equipment, and the continuation of that support contract has options in it that go over the life of the asset.

CHAIR—You fascinate me now. Is there an availability clause in the Collins contract?

Mr Watters—No. Once again, you would be into an argument about how it was being used and the way in which it was used would be—

CHAIR—That was a simple answer, wasn't it—no.

Mr GEORGIU—You would get into an argument about whether they work or not. That is a reasonable response. That is a response that they made to you, yet you actually do persist. How much are you going to temper your comment?

Mr McPhee—The recommendation points to a significant issue and I accept the points being made by the department, but what we are seeking through the recommendation is to provide a stimulus to continue to focus in this area to try to get the best balance. While we accept the points, I still think it is a case of not disregarding the issue that we are really trying to drive at, and that is how to manage life-cycle costs and the extent to which we try to tie down people who make statements about their life-cycle costs when they are seeking to gain Commonwealth business.

It is a genuine issue and I encourage Defence to continue to explore the options around this area, even if this recommendation may not be exactly on the money.

Mr GEORGIU—If they provide a compelling response, are you entitled to leave your recommendation in its existing form—hanging around without any change in the recommendation? In 10 years time some of us will say, 'We told you so.' It is a genuine issue. If they say that a recommendation does not work and they provide information on why it does not work, shouldn't you refine your recommendation to a point where you are willing to stand by it and have a fight over it, rather than just saying, 'We are trying to give a general direction and encourage them'?

Mr McPhee—I think the issue is that, as Major General Mueller has suggested, there are opportunities to tie down under contractual arrangements certain warranties, if you like, given in respect of life-cycle costings. So it is not an absolute situation; it is not a yes or a no, or agree or disagree. I think what Defence is saying in their response is that in areas where it makes sense they will seek to do this. That is the message I get—the mean time between failure type of approach.

I am saying we want to leave it on the table because it should be a stimulus for further consideration in this area. It would be a mistake on our part, of course, to drop one of our recommendations every time someone disagreed with it.

Mr Smith—I might add that one of the problems is that there is a commercial interest in understating life-cycle costs, which I think Mr Watters has already said. There is the belief that the comparison of two competing tenders is nevertheless still equal. What if one part understates more than the other? That is the problem. We recognise the solution is not ideal because of the issues that Defence has raised but, again, we think that is worth keeping on the table.

CHAIR—Both tenders are based on ideal conditions; they are not based on worst case scenarios. Who is going to give you a tender based on the least availability, considering it is estimated that they may break down 2½ times as frequently as you would want them to? Nobody is going to tender on that basis.

Mr Smith—Exactly, so you may not have valid information.

Mr GEORGIU—Following on from Mr McPhee's answer: Major General Mueller, do you think that your 'not agreed' response, given what you have actually said orally, is a hardline 'get stuffed'?

Major Gen. Mueller—I cannot recall who actually made the response to this. I am sort of an on the team leader.

CHAIR—The buck stops!

Major Gen. Mueller—The buck stops with me absolutely and in no way do I ever shrink from a robust exchange of ideas.

Mr GEORGIU—What you said was much more flexible than what this says. What you actually said was, 'We're trying and, where feasible and possible, we'll do it.' This says, 'No way, we'd rather die. It would never work in any circumstances.'

Major Gen. Mueller—If I could go back to a couple of points that have already been raised. Right at the outset I emphasised the fact that life-cycle costs are always incomplete and are always inaccurate, in spite of anybody's best endeavours. They must be, by definition.

On the issue of reliability, I talked about reliability improvement warranties and mean time between failure guarantees and the fact that my advice—and my understanding—is that where they have been attempted they have not been very successful, because reliability is an engineering issue. Engineering does, paradoxically, stand largely on judgments rather than necessarily on facts.

DAO have mentioned the issue of availability. I believe that putting in place through-life support contracts in parallel with acquisition is the best approach. In other words, you say, 'We want you to guarantee that we will have X platforms on line.' Then they have the

problem to deal with in terms of reliability and maintainability, because those two things are the determinants of availability. At the end of the day, what you are interested in is not so much reliability but availability. I think the way that it has been approached with a lead-in fighter is probably an example of how it ought to be done.

CHAIR—There are a couple of things I had better ask or my secretariat will never forgive me. Firstly, in recommendation 1 ANAO recommended that you establish and promulgate a brief overall policy statement. Have you done that?

Major Gen. Mueller—The answer to that is that the policy is in draft. I am not prepared at this stage to release that. There is a saying that more things are wrought by prayer than this world dreams of. That is not true of policy. I want the policy to be more meaningful before I am prepared to issue it. To do that, I need to make sure that I am aware of the outcomes of those two business process re-engineering exercises being run by the DAO and Capability Development Division. It is important in the policy statement to enunciate clearly who is accountable for what and when, otherwise the policy statement will not have any impact. Until the processes that are managed by both the Capability Development Division and the DAO have been settled, I believe that the issue of that policy document would not really contribute to any improvement at all.

CHAIR—How many people in Defence would be involved in life-cycle costing?

Major Gen. Mueller—Do you mean involved in the sense that they would actually do life-cycle costing analysis?

CHAIR—Yes.

Major Gen. Mueller—I could not give you a number. If you looked at the total Defence work force, the number would be relatively small. It is a highly specialised activity and it relates to people who are involved in the management of projects during the conception and acquisition stages, and it would affect people in my organisation in the logistic business units who manage the delivery of through-life support. But in terms of numbers I could not say.

CHAIR—To properly address all these recommendations, what would it cost you?

Major Gen. Mueller—More money than I think I am likely to have available.

CHAIR—Then why did you agree to most of them?

Major Gen. Mueller—If I could just expand on that. Policy aside, the way to ensure that life-cycle costing is addressed properly is to identify those jobs in Defence where that is a core competency. In other words, it is not a matter of encouraging people to have an interest in life-cycle costing. You actually identify that it is a core competency for a particular job, you then assess the competencies of the incumbent and, if they do not have the core competency, then you have a gap to close. That is the first issue. That is, broadly speaking, competency based training and assessment, and that is the first step.

Then there is the question of having the tools available for people. Highly sophisticated life-cycle costing models—with their associated cost breakdown structures and ready access to all the data that you need to populate those models—can attract very significant levels of investment. If I remember correctly, towards the back end of the ANAO report there is an observation to that effect, which I think has been derived from the United Kingdom. Being able to acquire those models and to have ready access to data which can populate them really means that you need access to a data warehouse. That does involve investment and I have to raise a business case to compete for that investment with all the other competing demands within Defence.

CHAIR—You still did not actually address the question. The question was: if agreeing to all the recommendations will cost more than you can afford, why did you agree to them?

Major Gen. Mueller—Sorry, perhaps I could put a rider on that. To pursue them to what I would call the ultimate—in other words, the way that they would be applied in an ideal world—is more than I can afford or more than Defence can afford. It is a question of being able to pursue them to the point where we can guarantee that the benefits of doing it outweigh the costs, but we are not going to be able to ever realise the ideal world as these recommendations would aspire to. That is all I am saying.

CHAIR—Let us consider, for instance, continuing to update the life-cycle costs of a platform through the whole use of the thing. Let us say a submarine has a 30-year life and you are still tracking life-cycle costs at year 20. Do you really intend to do that?

Major Gen. Mueller—I retire at the end of the year so the answer is no.

Mr GEORGIU—That is a good answer.

Major Gen. Mueller—What that means is that you need a data warehouse. If you are looking at the life-cycle costs of, say, an in-service submarine, you are looking at the costs that attach to the maintenance of all the systems, the sub-systems, the machinery and propulsion of the hull itself and its ammunition. You are looking at the costs that in fact you attract from suppliers. You are looking at all the training of your maintainers. You are looking at all the training not only of your maintainers but also of your operators. You cannot use those submarines unless they cooperate periodically with surface combatants and long-range maritime patrol, so a slice of the life-cycle costs of those systems has got to be bled into the life-cycle costs of submarines.

Unless you have a central data warehouse, quite frankly—given the work involved in doing that—you would have to question whether the benefits would outweigh the costs. But Defence has decided, in this brave new world of accrual based accounting and output based budgeting, that it would make sense if we were to pursue activity based costing. I am a strong advocate of activity based costing. In order to do that, we will have to create in Defence a central data warehouse.

CHAIR—You are going to have one hell of a chart of accounts, aren't you?

Major Gen. Mueller—Exactly. If we were able to do that—and some organisations in the private sector allegedly have—then I would suggest to you, Mr Chairman, that there were real prospects of being able to track life-cycle costs for major platforms and systems in service.

Mr GEORGIU—Did you get very much out of this report?

Major Gen. Mueller—Frankly, no. I make that observation not to be disparaging in any way of the Australian National Audit Office officers concerned. But I think it would be reasonable to say that we are probably aware of the problems which this report reveals quite accurately.

I think we all recognise it is easy to identify what is wrong; sometimes in the real world it is very difficult in fact to get it right. So, from that point of view, yes, there is nothing in it that is inconsistent with what I would perceive to be the situation with life-cycle costing within Defence. But the real challenge, of course, is to progressively pursue the implementation of the recommendations.

CHAIR—Anybody else?

Mr McPhee—Mr Chairman, if I may just pick up on that last point. I have a couple of things. Firstly, our reports are for the benefit of parliament first and foremost and, secondly, to point out areas for agencies.

In terms of the agencies that we audit, often our recommendations are not exactly earth-shattering for the agencies because you would be surprised if senior program managers were not aware of particular ways in which their own program performance could be improved. The point I made earlier is the important one: our recommendations are very often a stimulus for attention to these areas within a department where it is required and where it may not otherwise have been given, so through that arrangement our audit reports are valuable.

The other thing is that in this particular audit it is very much about how we believe Defence can improve their implementation of the policy that they themselves have established, so to that extent it should not be news to the department.

CHAIR—We do accept the premise that if it is your policy you ought to have some procedures in place to make sure the policy is implemented.

Mr Watters—I would be a little less harsh in my judgment about the report. From an acquisition point of view, I think it was a useful checklist.

CHAIR—I thank all our colleagues from Defence for coming today. It has been a useful session. We will eventually get to a report on this quarter of the Auditor-General's report. Thank you very much for your information. You can go back to keeping us from harm and to spending our money wisely.

[11.46 a.m.]

DAWSON, Mrs Jennifer Merran, Contractor (Pricewaterhouse Coopers), Australian National Audit Office

GREENSLADE, Mr Alan, Executive Director, Australian National Audit Office

HAYTON, Mr John Trevor William, Executive Consultant, Strategic Planning and Policy, Information Management Branch, Department of Foreign Affairs and Trade

KENTWELL, Mr Philip Charles, Acting Director, Evaluation and Audit Section, Executive Planning and Evaluation Branch, Department of Foreign Affairs and Trade

KUPA, Mr Miles, Deputy Secretary, Department of Foreign Affairs and Trade

McPHEE, Mr Ian, Deputy Auditor-General, Australian National Audit Office

QUINLAN, Mr Gary Francis, First Assistant Secretary, Passports, Services and Security Division, Department of Foreign Affairs and Trade

CHAIR—We now come to the second session of today's public hearing. I remind witnesses that the hearings today are legal proceedings of the parliament and warrant the same respect as proceedings of the House itself. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament. The evidence given today will be recorded by Hansard and will attract parliamentary privilege. The audit report being considered in this session is Audit report No. 44, 1997-98, *The Australian Diplomatic Communications Network—Project Management*.

I welcome representatives from the Australian National Audit Office and representatives from the Department of Foreign Affairs and Trade to the second session of today's hearing. The main purpose of this session is to examine the key issues identified in Audit report No. 44 of matters relevant to the project management of the Australian Diplomatic Communications Network. The committee is interested to learn what action has been taken or is planned by the Department of Foreign Affairs and Trade to address issues raised in the report. The committee wishes to examine DFAT project management practices, particularly for major high technology projects. I would like to provide an opportunity for a brief opening statement from DFAT and the ANAO. Mr Kupa, do you wish to make a brief opening statement?

Mr Kupa—Yes, Mr Chairman. I should explain first that I am here on behalf of the secretary of the department, Dr Ashton Calvert, who is leaving this afternoon on an overseas trip and is unable to come here himself. He has asked me to represent him here.

We welcome this opportunity to discuss with you our response to the ANAO audit of the project management of the development and implementation of the Australian Diplomatic Communications Network—known by its acronym ADCNET, a bit of a mouthful—and we are very ready to respond to any further questions that you might have.

I would like to recall here that we do agree with the recommendations in the report. The report and its recommendations have been of assistance to the department in formulating better practice management and quality assurance strategies. Indeed, the recommendations have helped us very specifically in regard to better management procedures for the human resource and financial management systems that are currently being installed in the department. I am sure that they will also be of assistance when we consider a successor system for ADCNET.

There are a few other points I would like to make. Let me reiterate that the department regards the ADCNET project as having been a success. ADCNET has not just provided improved capabilities and functionality; it has really revolutionised the way the department operates. Prior to ADCNET there were no proper, secure, desktop office automation facilities available to officers of the department. Word processing was only available from centralised word processing pools which officers had to scurry to and from. The diplomatic cable system required that every cable be created down in the diplomatic communications centre, even if it was already typed up beforehand elsewhere in the department. Email services did not exist. With the rapidity of technological change, it is sometimes sobering and salutary to remember the rather primitive level of office automation that did exist only about 10 years ago.

ADCNET today is used on a daily basis by Australia based officers in our head office in Canberra, by officers in the states where we have offices and also at our overseas posts. Moreover, it is also used by a number of other government agencies, including the Department of the Prime Minister and Cabinet, AusAID, the Office of National Assessments and parts of the Department of Defence. Contact with them is feasible through ADCNET. The user feedback we have suggests that, today, 10 years down the track, users still find great value in the system.

It is my understanding that no other foreign ministry anywhere has been able to deploy a secure office automation and messaging system in the way that we have with ADCNET. Indeed, there have been quite a number of other foreign services that have come to us seeking advice on how to implement similar systems. Most of the staff of the department are concerned with the ease of operation of the system and the immediacy it brings to their ability to create ministerial briefs, submissions and follow-up communications through the international network. It really is quite extraordinary.

A couple of weeks ago I was in Washington—if I may personalise this for a moment—for some fairly sensitive discussions. The embassy was required to do a follow-up report on that and, rather than just having a stab at it after I had left and sending it off, they were able through ADCNET to send a draft down to me here in Canberra, I was able to check over it and adjust a few nuances and send it back, so the report that came through was a much more definitive report.

We can get access to the cables from any of our posts through the ADCNET systems. Without needing to have hard copies distributed around the department, we can get it up on the screen. We are also investigating ways in which officers, for security reasons, who might not actually need a hard copy, may be able to read a copy on the screen. They will not be able to get a hard copy but they will have access to the information. All that is possible with

ADCNET. It really has made a big difference to the way we work, and it has been of great benefit.

I recall that the original submission to government justifying the substantial investment in ADCNET pointed out that there should be a significant saving in staff resources. I note that the audit report acknowledges in section 2.7 that those projected staff savings were exceeded.

Timeliness of implementation of ADCNET has been a continuing challenge to the department. I would suggest that if one takes into account all the benefits—

Mr GEORGIU—A scheduled challenge.

Mr Kupa—Thank you. Those delays have not hindered the department's operations. If one is looking for silver linings, the delay assisted us to develop a variant secure system that requires less administration and less operator sophistication to manage. That is going to be installed in the remaining posts and three state offices this calendar year. That will complete the worldwide deployment of the secure system as originally envisaged.

Year 2000 compliance is a current priority, as is replacement of what is known as the central message switch in the system. Year 2000 compliance has taken significant resources to develop, as has the conversion of the ADCNET release 1 systems to make sure that they are year 2000 compliant. That year 2000 compliant system, known as ADCNET release 2, is being deployed in the central office, and conversions of posts' systems overseas will begin shortly.

The replacement of the central message switch was part of ADCNET release 3. We expect that much of that capability will be operational by this September. That would be a significant part of the outstanding work in ADCNET release 3. With the prime system integrator, BHP Information Technology, we have worked hard and cooperatively to achieve this result. We acknowledge that no delays in implementation would have been preferable, but I think we should keep in mind that deployment of the ADCNET system represents the successful implementation of a really major and complex information technology project. These kinds of projects do not always succeed; they pretty often fall over.

There was a story in the magazine the *Economist* on 17 April which referred to your British parliamentary equivalent, as I understand it, the Parliamentary Public Accounts Committee, which examined 40 computer projects which had gone seriously wrong over recent years. IT projects of this scope and dimension are notoriously risky. We are profoundly grateful that the management systems we adopted—notwithstanding that, with hindsight, they might not be state of the art in today's terms—did provide a satisfactory outcome that has been much appreciated around the department.

I did say at the outset that the department agreed with the recommendations made by the ANAO audit subject to qualification of recommendation No. 5. Moreover, we have included the substance of the recommendations in our approach to management of IT projects. It is always easier with hindsight to see how things may have been done more effectively. That is probably a refrain you have heard before, but it is valid. We recognise that significant strides have been made in the development of project management principles and in methods of

providing quality assurance. These developments have come through over the last decade during which we have been putting ADCNET in place.

We are investigating the application of best practice guidelines for project management issued by the Australian Institute for Project Management for our use in all future information technology development projects. The qualification to recommendation No. 5 related to our concern at the time about the utility of independent quality assurance. Let me say clearly that we do believe in and use quality assurance processes in our information technology projects. In the past there was perhaps not a sufficient appreciation of the value of such advice being independent, but we now acknowledge the value of that approach and we intend to pursue it in the future. That will be part of our assessment and management, for example, of the two other systems that we have under way at the moment—that is, the financial and human resource management systems.

We also believe that the value of the audit recommendations in this report will be demonstrated through outcomes generated by improved management procedures that we are adopting. We would like to see productivity gains and cost savings similar to or greater than those achieved through the implementation of ADCNET in the deployment of our next generation systems. We propose to manage them very definitely in both the development and implementation phases in a best practice way.

We have already taken significant steps to implement better practice project management for IT systems. Over the past two years we have prepared a major new information management strategy which sets out some new directions. Several of the key elements underpinning the strategy respond to observations made by the audit team. The information management strategy that we have now adopted recommends the creation of a new and simplified governance structure within the department for information management issues.

We have taken steps to implement those recommendations and we have created an Information Management Advisory Group, IMAG, to advise the department's senior executive. There is also a Consultative Committee on Information Management, CCIM, to ensure appropriate contributions at a more tactical level from the users of the systems. Within that framework, we expect the project management arrangements for future major IT projects to be simple and easy to manage. We also expect them to enhance the accountability and transparency of IT development processes.

I think it is probably true to say, too, that departmental senior management is more familiar now with the language and milieu of information technology and information management than it was in the past. That is, I guess, a general trend that has been happening across the Australian Public Service and industry in general. I think there is a greater capacity now to question processes and determinations, that what does occur should be something that is comprehensible to ordinary mortals. There are still the occasional Luddites around the system and the occasional nervousness at senior levels when approaching some of these technical issues, but that is diminishing. We are better prepared now at the senior management level to effectively manage the risk environment.

In conclusion, I would like to reiterate the department's happiness and satisfaction with the outcomes that we have received from the ADCNET project. I would like to emphasise

again our agreement with the ANAO audit report recommendations, which, if I may say so, were very clearly and lucidly expressed in the report. We expect those recommendations to assist us in undertaking future projects more effectively. We remain very willing to implement any remedial or additional measures to improve the project management and quality assurance measures applicable to future information technology projects. Thank you very much.

CHAIR—Thank you for that. Mr McPhee, do you have anything to add?

Mr McPhee—Mr Chairman, I do have an opening statement which goes to the audit report and the department's response. Given Mr Kupa's very comprehensive opening statement, if you would be happy, I would like to table that.

CHAIR—Is it the wish of the committee that the document be incorporated in the transcript of evidence? There being no objection, it is so ordered.

The document read as follows—

CHAIR—Mr Kupa, you described this project as a success. It is now five years late and still over three years from completion. How on earth can a five-year late project be described as a success?

Mr Kupa—My understanding is that by far the larger part of the project was implemented within a reasonable time frame and that the delay relates to the last phase of the project. There were very substantial benefits obtained from ADCNET Release 1 being updated now into ADCNET Release 2 to make it Y2K compliant. Those very substantial benefits have already flowed through. That was the basis for my comments about having revolutionised the way we work and having brought very significant benefits. But we do acknowledge that, yes, there has been a delay in the last phase of it, although even there my understanding is that significant elements of its functionality are already being implemented and are clear.

CHAIR—Mr McPhee, do we have a Collins class situation arising with DFAT's contract with the major contractor in that they have spent the money and do not have the systems?

Mr McPhee—I think it is a different situation. Perhaps the department might explain how the contractual arrangements work, but I imagine it would be based on delivery at particular stages of the contract, Mr Chairman.

Mr Kupa—That is my understanding, Mr Chairman.

CHAIR—Can you respond to that?

Mr Kupa—My understanding is that it was done on a phased basis. That is the basis for my statement that the larger part of the benefits from the whole project have already been realised to the benefit of the department's operations.

CHAIR—I think the committee would like some information—don't you agree colleagues?—on what you have spent to date and your estimate of cost to complete, together with the total final expected contract value.

Mr Kupa—We would be very pleased to provide that, Mr Chairman.

Mr Greenslade—Mr Chairman, I point the committee to page 26. Chapter 6 generally does run through some of the expenditure to date at the time of the audit and the foreshadowed expenditure to complete the project. I refer to table 2 in particular.

CHAIR—No, that says 'funds available', it does not say 'cost to complete'. That is different, with respect. The cost to complete may be substantially different from the funds available.

Mr Kupa—My understanding is that we expect to complete the project within the funds available.

CHAIR—Okay, but if you can provide us with that information we would indeed be grateful. The audit report states on page 13 that the ADCNET steering committee did not

meet for significant periods of project development from October 1992 to December 1994, from April 1995 to April 1997, from August 1997 to December 1997 and from October 1992 to December 1992. How on earth did you expect to manage a project in the order of \$100 million in value, with a long time span for implementation, without control of the project?

Mr Kupa—My understanding is that, notwithstanding that those meetings did not occur more frequently, there were other consultative processes and mechanisms through which the necessary work was done. It may not have been at the level originally envisaged and, as the report notes, there may not have been full documentation of some of the work that those alternative consultative processes undertook, but I would suggest that the project nevertheless went ahead and the way it has been realised has very much met the department's expectations and needs.

CHAIR—But you are five years late. If management does not have control of a project throughout the lifetime of the project and does not have continuous updates of when completion is expected in agreements or otherwise with the contractor in terms of the revised time schedule, how on earth do you control the project? I am lost.

Mr GEORGIU—Mr Chairman, I would like to reinforce that point.

CHAIR—That is really appalling, quite frankly.

Mr GEORGIU—If you have a look at page 13, there were two-year gaps between the meetings. Meetings of the steering committee did not occur when significant delays and significant implementation problems were occurring. That is on the basis of the audit report. This are not just saying, 'Oh, everything's going well, so what the hell.' This is in the course of a project that ran into significant difficulties, and there are two-year gaps. Two years is a big gap. It is not saying, 'Let's defer next month's.' This is a two-year gap. I am not good at maths, but April 1995 to 1997 is two years. October 1992 to December 1994 is over two years. Once again, meetings did not occur during critical times at which vital delays and problems emerged. Why didn't the committee meet for two years at a time?

Mr Kupa—We have acknowledged that those meetings should have occurred, but we have also pointed out that there were alternative consultative mechanisms operating at the time. I would suggest that if one were to consider the effectiveness of those one needs to see what the outcome of the project has been and whether it is a success.

Mr GEORGIU—It is a project that is five years delayed. Significant problems occurred, significant delays took place during the period that committee was not meeting. It is not as if you could say, 'Oh, we don't have to meet because everything is going fine.' Are you across those gaps and what actually occurred in that period? I find it remarkable, and that is not an overstatement—you will have to wait until later for overstatements that do not make sense. Didn't you say, 'Hey, what's going on?' You had delays, deferrals and implementation problems and the committee did not meet for two years, and then not for two years later on. Why? Is there an explanation?

Mr Kupa—Could I assure you that we are certainly taking these observations to heart, and in the systems that we have in place now—

Mr GEORGIU—I would like an explanation why they did not take place. Two years is a long time in politics. Somebody must know why that committee did not meet over these critical and protracted periods.

Mr Kupa—Amongst the collective knowledge of the officers who are working in these area at the moment, I do not have a detailed explanation to offer as to why they did not meet, but I am assured that the necessary issues were discussed, the necessary evaluations did take place and the necessary decisions were taken. I think the proof of that is in the fact that the system is now operating to the considerable benefit of the department. But we do acknowledge that the actual operation of those consultative mechanisms was not ideal.

Mr GEORGIU—And the outcome of going to something that would revolutionise the operation of the department with great success is that it has been delayed for five years.

Mr Kupa—With the greatest of respect, that is not a statement relating to the entire project. It is not as if we are still on hold, operating with the systems we had 10 years ago and waiting for this interminable delay to come to an end so we can finally implement ADCNET. The greater part of the benefits of the implementation of ADCNET has already taken place. What we are talking about in terms of the five-year delay, as I understand it, relates to the last phase of the project.

Mr GEORGIU—Which is quite significant.

Mr Kupa—My understanding is that it incorporates a number of refinements to a system that has already revolutionised the way we work and that it also involves a new central switching system which would be of benefit. Okay, there is a delay on that, but the larger part of the project has been in play and operating to our benefit for quite a while already.

CHAIR—You must have an original contract schedule which would included expected payment dates. Is that correct?

Mr Kupa—Yes.

CHAIR—I am sure you do. We would like to see the original project schedule against what actually occurred, including payments, and then what you originally anticipated to be the savings in operating costs, at what date and what has actually occurred. If the project is five years late and there is an \$8.8 million per year saving in operating costs because the system is operating, over five years that is almost \$45 million that has been forgone as savings that you did not achieve. That is a wild guess on my part which might be totally erroneous, but being late has further implications than just not being able to use the system. There is the fact that you were projecting cost savings at some point during the project that the Commonwealth has no longer achieved, and that is big bickies.

Mr Kupa—We would be happy to provide the detail that you have asked for, Mr Chairman. Let me also mention—it is not explicitly referred to in any of the documentation you have—that there has also been a legal case which arose out of the implementation of this project and that has led to some delay in this final phase. Nevertheless, I reiterate the point that the major benefits of the project were not delayed and have been implemented.

CHAIR—You can show us that in time schedule terms and in dollar terms. Am I clear on what I want?

Mr Kupa—Yes.

CHAIR—I want the points at which the savings were supposed to start occurring, how much they were and what has actually happened against the original schedule of progress payments and the final schedule of progress payments.

Mr Kupa—We understand.

Mr Quinlan—We understand that and we will provide the information.

Senator GIBSON—Can you also tell us a bit about this litigation that is on hand?

Mr Kupa—I can say a little bit about it without speaking to the detriment of the Commonwealth's interests in the matter. There was a contractual dispute between contractors involved in the project, and that has led to a counterclaim against the department. But it would not be beneficial—in fact, it would be the reverse—to the Commonwealth's interests to explain that in any detail. But in case this observation has aroused some concerns on your part, I would like to say that, on the basis of advice from senior counsel and the Australian Government Solicitor, we are confident of our position in that legal action and confident that we would be able to minimise any damages that might flow from that. We are confident of our position; I would not want you to be left with any concerns about that.

Senator GIBSON—This is a general project management issue. First of all, you said in your opening statement that you now believe that the system you have—where it is operating—is basically the best in the world or equal to the best in the world. Is that correct?

Mr Kupa—That is my understanding. I travel a fair bit and talk to people in other foreign services. When one discusses the respective systems, they are pretty impressed.

Senator GIBSON—That implies that the original specification was obviously very well done quite a long time ago. But then, as the ANAO point out, the fact that the project management had such a long delay in getting it implemented comes up again. Unfortunately for us on the public accounts committee, it seems that, when we look at where considerable capital is expended, there is a stuff-up on project management every time. It seems like within the Commonwealth we do not know how to go about carrying out major projects of capital expenditure. Are you really saying this morning that you think that message has got through in your department? Is that correct?

Mr Kupa—That is the clear message I have. I am fairly new in this position, but having inquired about it over recent weeks in connection with this hearing, that is certainly my impression. Let me also say that, when this project was embarked upon a decade or so ago, it was recognised that it would be a huge innovation—not just in Australian terms, not just in foreign service terms, but in terms of general foreign service management. You have complex systems traversing the globe, you have very high security needs and you have a variety of functions that you want the users to be able to perform. This was something really

quite innovative and challenging, and the degree to which those involved in those early stages set up the design parameters and scheduled it is something of a tribute to them.

Further down the track over that decade, as we have all learned more about project management, one can see that it might have been better managed in some ways. It did not meet best practice as it was emerging during the course of this project. Nevertheless, it has been a substantial achievement, notwithstanding that we do have a number of difficulties in the last phase, including some of a legal nature.

Senator GIBSON—In our experience over the last few years on this committee, there have been a couple of defence projects: JORN, Collins class. Again, what shines out is lack of proper project management from the very start, hence enormous delays and enormous cost. Yours appears to be a delay-only thing. It would appear that, amongst Commonwealth agencies, not enough emphasis has been placed—in past years anyway—on recruiting topnotch project managers to make sure these capital projects are followed through and achieve both cost and time outcomes.

Mr Kupa—Let me say that, in response to that, I do not feel any temptation at all to comment on the management elsewhere in the Public Service.

Senator GIBSON—I understand that; but we are concerned. Here we are, we look at a few things and this is what we are finding.

Mr Kupa—Yes.

Senator GIBSON—We want to get the message through to all the other government departments and agencies to put an enormous amount of effort into finding good people to run projects and to do it professionally.

Mr Kupa—It is evident that this report has already been and will continue to be of considerable value to this department. The way it sets out best practice in various areas rather than picking on particular holes that it might perceive in the way that we have done things and the way it sets out something of a road map—that is, sets out guidelines for operating different parts of project management—is extremely useful.

Senator GIBSON—This committee is also pleased that the government is at long last implementing accrual accounting, which means that we can get our hands on where the capital is being spent. We could not do that before. That will hopefully roll through all the agencies. Once we know what is going on, we can chase things through and ask the proper questions; before, no-one knew. Would you agree with that?

Mr Kupa—Accrual accounting is being implemented in our own department. We are restructuring our various documentation, our annual reports and our budgetary documentation, to accord with that. It is a little harder for a department whose product is in some respects more intangible, less quantifiable, than that of other departments to implement some of these new systems, but we still think it is of considerable value.

Senator GIBSON—With them separating out capital expenditure and capital budgets from operating ones, at least we know now how much capital has been spent in various departments and agencies because they are all set out in the budget documents. We did not know before.

Mr Kupa—With your permission, Mr Chairman, I will make a supplementary observation about the financing issues that you raised earlier. This relates to the delay in the final phase. I am advised that there has been no increase in costs. BHP Information Technology has agreed to comply with the costs in the contract ITB002. The department has agreed to extend the timetable for delivery under the contract. I would not infer from what has happened there that there has been an increase in costs to the Commonwealth.

CHAIR—That is reassuring, but you understand there is another point—that is, we do not have the system, therefore we are not achieving the savings that the system is designed to achieve. That is a cost.

Senator GIBSON—An opportunity cost loss.

CHAIR—It is more than an opportunity cost. Maybe you think I am being particularly aggressive, but the purpose of my question is to try to assure myself and the committee that you have the message that you really stuffed up. This was very bad project management. You finally got a successful outcome and something that you are happy with. I am very pleased about that but, in the meantime, it has cost the Commonwealth money—and there is little doubt about that—because you did not have the system when you had expected to have the system. Therefore, you did not achieve the manpower savings that you would otherwise have achieved. We want to make sure that, the next time you enter one of these, you have the message that we do not want to go through this again in another two, three, four, five or 10 years. Is that understandable?

Mr Kupa—Yes. I do not mind having a direct and frank discussion on these things. In this, we are seekers after truth as well and seekers after improvement. If we can learn from the debate here, that is useful to us. Could I invite my colleague Mr Gary Quinlan to make a couple of observations here.

Mr Quinlan—Mr Charles, we understand very clearly what you are saying. Lessons have been learnt here. Mr Kupa and I started our jobs on the same day only about eight weeks ago. We are still coming to grips with some of this. I have to say that—and this is not just for the sake of saying it—reading this report by the ANAO has been extremely helpful to me personally in coming to grips with the major project managed by the department in the last decade. As you have requested, we will provide you with the information that you are seeking and perhaps a statement that goes with that which indicates the context in which we might be able to evaluate the project.

In looking back over the decade, I was impressed by the novelty of what we had embarked on. There was no commercial technology off the shelf that we could just pull down to utilise in this scheme. It is a unique scheme. The United States, for example, admits that it is at least five years behind us in the State Department in the development of a comparable scheme. We learnt a lot as the project unfolded.

Release 3 is where the delay is. The legal situation is a real complexity. It has been going on for some time and we are still at the preparatory stages of the legal case. This is not a healthy prognosis in respect of the time that might be involved, but we have consciously brought forward significant elements of what would have been in R3. The benefits have been brought forward into the progressive upgrades of the R1 release for ADCNET, including some of the significant security features.

I should also comment that we hope—in fact, we anticipate—that by later this year the critical element of R3 will be achieved, which is the message switch that is the key for us in our future IT. Further parts of the R3 menu are enhancements—some security audit trails will be improved, and there will be quicker capacity with emails in certain ways. It comes down to a whole series of very desirable improvements, but they are not critical in any sense to the functioning of the department. A lot of those refinements which were originally conceived as part of R3 have been brought forward, but we will set this out more clearly on the piece of paper that you requested.

CHAIR—That would be helpful. I have just one technical question, because you have wrapped the system up. I accept that it was a while ago, but in the *Canberra Times* on Monday, 13 April 1998 in a column called ‘Ratbag’—do not take any notice of that—the article says:

When next the Office of Government Information Technology and Outsourcing or perhaps even the Australian National Audit Office are looking at Commonwealth communications systems purchases they might care to look at the Department of Foreign Affairs and Trade.

Why? Because Ratty is given to understand that DFAT’s ADCNET system is not to the liking of all its users.

The problem? The critics allege the system is not all that communicative with other systems.

Can you comment on that? I am not purporting that what the press says is in any way accurate.

Mr Kupa—I venture to suggest this might be a usually unreliable source, Mr Chairman. However, let me say that one of the essential components of the ADCNET system is that it does not communicate with other systems. It is a secure system. It links officers with the relevant security clearances here, in state offices and at our overseas posts. It is not intended to communicate with other systems, so I am a trifle puzzled by this criticism.

CHAIR—Would ANAO like to make any comments about what we have discussed so far?

Mr McPhee—The central issue the committee is raising is the project management and how we can get it better. Could I ask Merran Dawson if she has any observations to make in this area, because she works in this area, both in the public and the private sectors.

CHAIR—Delighted.

Mrs Dawson—The key observation, from listening to the discussion, is that we knew all the risks at the outset. We knew that it was innovative, we knew that it had not been done

anywhere else in the world, and we knew that the security needs were complex. Against that risk profile, you would expect that we would have very good management processes and that we would be right on top of that risk profile and actively managing and demonstrating that. As we have discussed, that was not what we were able to find.

We were talking earlier about the steering committee. Your comment about other processes in place to perform some of the functions that the steering committee should have been performing was also raised during the audit. The difficulty we had was in substantiating that that was the case from looking at minutes and trying to establish the accountability and the trail that existed to support those assertions.

CHAIR—Mr Kupa said that you said project management has really moved on in the last decade and that 10 years ago we did not know much about project management. Senator Gibson and I—being more or less old-timers—having come from the private sector and having managed very large projects with very big amounts of money would say you are wrong. I am sure Senator Gibson will agree with me that you are absolutely wrong. Project management systems have been in place for decades and might have been more than adequate to have assured yourselves that you were actively on the job, day by day, managing the project. Page 13 gives me no confidence that DFAT was managing the project at all.

Mr Kupa—Perhaps in the private sector things were somewhat different. In the Australian Public Service perhaps they were not up with all of these things. One can also say that a lot of those guidelines that are available for public service management of major projects have come out over that decade during the course of the management of this project. They were not so well defined or so well set out at that earlier stage.

I think one also needs to take into account that this was—as Mr Quinlan has said—a very novel and a very large project for the department to take on board. The processes, with hindsight, may not have met best practice evolving through that period. We have acknowledged that, and we have taken steps to make sure that our processes for current and future projects are much better.

Senator GIBSON—How far away are your next generation systems and reviews?

Mr Kupa—My understanding is that we are exploring a number of options there, but decisions on that have not yet been taken.

Senator GIBSON—Are we talking about multimillion dollar projects or minor enhancements of what you have got?

Mr Kupa—Nothing of the magnitude of ADCNET. My understanding is that what is being explored are the options, and that they would build very much on what has been achieved through ADCNET. My expectation is that it would not revolutionise work practices to the same degree as what has occurred with ADCNET. It would be, from the user's perspective, a more incremental kind of improvement. We are working out the technical side of it. There are budgetary considerations as well.

Senator GIBSON—The project management, I am saying, too.

Mr Quinlan—We would be relying much more on what is commercially available off the shelf as well so that we would not have the novelty of developing in house so much of what earlier had to be done.

CHAIR—Page 23 of the audit report indicates that there was no internal review of this project by the department's internal auditor. Another area that the committee is particularly interested in is the internal audit procedures of departments—how frequently they are used, and how good they are—so as to relieve us and Awn of the burden of constantly having to talk to departments about the issues. I would have thought that internal audit functions ought to fix a lot of it.

Mr Kentwell—The role of internal audit in DFAT is continuing to develop. We are moving further away from the traditional compliance auditing role into performance auditing, which picks up these sorts of control assurances and provides assurances back to the chief executive. In terms of the ADCNET project, internal audit was not involved. In hindsight, and certainly looking at the recommendations of the report, we should have been involved and we are certainly moving now to involve ourselves in providing assurances, through the audit committee, to the executive, and to steering groups and committees which have been formed over more recent acquisitions and projects, such as the introduction, as Mr Kupa suggested, of our finance management information system and our human resource management information system.

CHAIR—In future projects, would you involve yourself to the extent that you would be keeping track of the fact that project management is meeting, that project management is managing the project and has some idea where the project is with respect to schedule, with respect to cost, and with respect to cost to complete?

Mr Kentwell—We have devised a pro-forma template based on Institute of Project Management literature on better practice for project management which picks that up and it is incorporated into our reporting.

CHAIR—Very good. Thank you. Do you intend to undertake a formal review of the overall effectiveness of the ADCNET project?

Mr Kupa—Yes, we do.

CHAIR—When?

Mr Kupa—I will ask Mr Quinlan to pick that up.

Mr Quinlan—That is clearly a very important element of the report, and it strikes one when you read it for the first time, I have to say. Yes, we would be doing that. Where we stand at the moment is that we intend over the next few weeks to go back, through our Information Management Advisory Group—which is the strategic steering group for information management strategies in the department which has been established since this report—and discuss the future of IT in the department, including building on the lessons specifically to come out of the ADCNET project and, of course, talking as well about user needs for the future. As part of that, we would be talking about how we can have a more

structured performance assessment which can build into our future thinking in carrying IT forward.

As Mr Kupa has indicated, we are in the process over the next six months or so of looking at what our future needs are and how best to achieve those, and that performance assessment is an essential part of that process over that period.

CHAIR—You talk about risk management; have you got anything in place to see that the Commonwealth has insurance in case NATO takes out one of our embassies? You do not need to answer that.

Mr Quinlan—You would note, Mr Charles, that we did not respond to that.

CHAIR—Does ANAO have any final comments they would like to make?

Mr McPhee—Just to say that it is pleasing to see that the department has responded so positively to the recommendations. If I could make a point: it demonstrates the positive stimulus that an audit report can provide to a department.

Mr Kupa—Thank you for those comments. They do accord with my understanding of the seriousness with which we have taken on board the messages in this report. May I say too that I think discussions of the nature that we have had here today will also assist us in the future.

CHAIR—We would hope so. Thank you very much.

Proceedings suspended from 12.38 p.m. to 2.03 p.m.

FURLER, Ms Liz, First Assistant Secretary, Health Services Division, Department of Health and Aged Care

JOHNSON, Mr Mark, Assistant Secretary, Financial Management Branch, Corporate Services Division, Department of Health and Aged Care

MOSSOP, Mr Michael, Director, Special Access Programs, Acute and Coordinated Care Branch, Health Services Division, Department of Health and Aged Care

COCHRANE, Mr Alistair, Chief Financial Officer, Department of Finance and Administration

JACKSON, Mr Neville Grant, Director, Accounting and Governance Framework, Department of Finance and Administration

BOURNE, Mr Denzil Hunter Ronald, Senior Director, Performance Audit, Australian National Audit Office

CRONIN, Mr Colin Douglas, Executive Director, Performance Audit, Australian National Audit Office

HOLBERT, Ms Frances Elizabeth, Senior Director, Performance Audit Services Group, Australian National Audit Office

McPHEE, Mr Ian, Deputy Auditor-General, Australian National Audit Office

COLLINGS, Mr Jonathan David, Assistant Secretary, Reporting and Resource Services, Department of Defence

FITZGERALD, Mr John, Director General, Contracting Policy and Operations, Defence Acquisition Organisation, Department of Defence

NEUMANN, Mr Claude, Inspector General, Department of Defence

CHAIR—We now come to the final session of today's public hearing. This afternoon we will be taking evidence on Audit report No. 47 of 1997-98—*Management of Commonwealth Guarantees, Indemnities and Letters of Comfort*. The committee has received one submission from the Department of Defence in relation to Audit report No. 47.

I remind witnesses that the hearings today are legal proceedings of the parliament and warrant the same respect as proceedings of the House itself. The giving of false or misleading evidence is a serious matter and may be regarded as a contempt of parliament. The evidence given today will be recorded by Hansard and will attract parliamentary privilege. I refer any members of the press who are present to the committee's statement about the broadcasting of proceedings. In particular, I draw the media's attention to the need to report fairly and accurately the proceedings of the committee. Copies of the committee statement are available from the secretariat staff.

I welcome representatives from the Australian National Audit Office, the Department of Finance and Administration, the Department of Defence and the Department of Health and Aged Care to the final session of today's hearing.

From the committee's perspective the main purpose of this session is to examine some of the key issues identified in Audit report No. 47. These issues are not new to the committee as they were the subject of a previous public hearing in 1996. The committee will be interested to hear of action taken to progress the issues identified in its previous report as well as action taken to address the concerns outlined in the more recent report by the Audit Office. With that background, I would like to provide the opportunity for brief opening addresses from the relevant departments and the ANAO. Would Finance and Administration like to lead off?

Mr Cochrane—Thank you for the invitation to give evidence to the committee today on this examination of Auditor-General report No. 47. The government's overall strategy in the management of the Commonwealth's guarantees, indemnities and letters of comfort is to limit the financial exposure in the first place to situations where it is clearly in the Commonwealth's best interests—that is, where the expected benefits outweigh the potential losses and where risks are accepted to manage the operations or activities such that, to the extent possible, they do not eventuate. DOFA's role as a central agency is to set the legislative and policy framework in relation to the control and management of financial risk exposures and provide broad based practice guidance. This framework is designed to support accountability for compliance with policies and guidelines in relation to contingent liabilities through, for example, clearly conferring on chief executives of FMA agencies the responsibility to manage the affairs of the agency in a manner that promotes the efficient, effective and ethical use of Commonwealth resources. Recognising that the management of these risks is largely in the hands of agencies, the department provided guidelines in 1997 on the issuing of indemnities, guarantees and letters of comfort. These promoted a strengthening of administration and management practices in relation to risks associated with these contingent liabilities that the Auditor-General identified in his previous report, Audit report No. 6, as needing improvement in agencies.

I note that in report No. 47 the Auditor-General has observed a marked improvement in the guidance provided to agencies regarding the disclosure and reporting of Commonwealth guarantees, indemnities and letters of comfort. My department gave unqualified support to these recommendations in this report and supports a general conclusion that the improvements made to the disclosure reporting and accountability arrangements since the 1996 report No. 6 have enhanced the transparency of material Commonwealth contingent liabilities. I am happy to answer any question from a departmental or whole of government perspective on the report.

Mr Collings—We have provided a short submission which is essentially an updated progress report on action that we have taken with respect to the recommendations in Audit report No. 47. I do not have anything else to add to that at this stage.

Mr Johnson—The extent of the Commonwealth's guarantees, indemnities and letters of comfort administered by the Department of Health and Aged Care is very limited. The indemnities and guarantees that the department has mainly relate to CSL Ltd. The

department has maintained a register of guarantees and indemnities for the last few years. This register is reviewed every 12 months for report in the department's annual financial statements. The department has specific chief executive instructions and procedural rules on both insurance and indemnity and risk management, which provide guidance to departmental officers.

In accordance with the chief executive officer instructions, the department is only able to enter into indemnity arrangements with the authorisation of the minister. The department's business planning guidelines emphasise the need for an assessment of risk, including contingent liabilities such as the grant of indemnities. Business plans also address the development and implementation, as necessary, of specific cost-effective measures and strategies to minimise risks in the department. The department is examining the establishment of a contract register linking it to the new financial management system to be introduced next year.

Overall, the department's standard contractual documents contain appropriate clauses in relation to contingent liability coverage to and from the Commonwealth. Non-standard contract documents that are developed on a case by case basis must be cleared through the Legal Services Branch prior to being signed by the approving delegate. As noted in the ANAO report, this department supported all the recommendations in that report.

Mr McPhee—I have an opening statement which summarises the audit findings and which, if you are happy, I would like to incorporate.

CHAIR—Is it the wish of the committee that the document be incorporated in the transcript of evidence? There being no objection, it is so ordered.

The document read as follows—

Mr McPhee—I will make a couple of other comments. As you have indicated, this is our second review of this area. It is showing an improvement in administration in this area which is pleasing to see. The overall level of capture of these instruments has improved and, despite the higher level of capture, the level of recorded financial exposure has dropped, in a minor way, as set out in the table on page 14. So, fundamentally, it is an improving situation, which is good to see.

CHAIR—Thank you for those comments. I guess, because I was not on the committee in 1996 when the committee looked at this issue the first time and, as we were just discussing briefly with colleagues from ANAO, it seems to me—coming from the private sector—that I cannot imagine how you would not always have had a register of guarantees and indemnities. It is beyond my imagination how a departmental secretary who is essentially a CEO of an organisation—a member of the board of directors—could fulfil their responsibility without having a register of liabilities. I note that Defence had two minor qualifications to the recommendations. We have discussed those qualifications.

ANAO has, in fact, written one of them off and said, ‘You are correct.’ That was in respect of recommendation No. 4. In recommendation No. 2, your qualification is essentially that you have a central register and that you register every contract over \$5 million. ANAO is happy with that procedure and sees it as cost effective. It simply makes the point that you keep that under review. So I am actually delighted to say, ‘Well done, Defence’—because we talk to Defence very frequently on a great range of issues and we are not normally so nice. We are really quite pleased with that. I know that Finance is not here to represent the OASITO. What is that?

Mr Cochrane—The Office of Asset Sales and Information Technology Outsourcing.

CHAIR—Maybe you can comment anyway. They did qualify their acceptance of recommendation No. 6. They consider that what is most important is the review and evaluation rather than the establishment of procedures. OASITO are concerned about a focus on procedures rather than on substance. In addition, they would qualify this recommendation with explicit considerations of cost effectiveness. I have some problems with that qualification, quite frankly. I would have thought that a very important responsibility of a board of directors was to make sure that they had an absolutely airtight record of liabilities. Would you disagree with that?

Mr Cochrane—No, I would not disagree with that.

CHAIR—So in this case the issue is not so much the outcomes but the procedure, I would have thought.

Mr Cochrane—Yes, I would agree with that comment too. I can only suggest that OASITO made the comment in relation to the sheer volume of indemnities that they actually issue each year. That is maybe how the qualification arose.

Mr GEORGIU—The more you issue, the less you need to document that?

Mr Cochrane—We could go back to OASITO and ask them to further clarify that, if that is required.

Mr GEORGIU—Could you please?

Mr Cochrane—Yes.

Mr GEORGIU—I noticed in its introduction that the Department of Health and Aged Care said that it had established a register of guarantees and indemnities, and letters of comfort.

Mr Johnson—Yes.

Mr GEORGIU—You said that you were examining the establishment of a contract register. What are you examining? You have agreed with the recommendation, so what does ‘examining’ actually mean?

Mr Johnson—It is a way of being able to efficiently and effectively capture the information that we need or that you would want to capture in a central register on contracts. We have a large number each year. Our current financial management system really would not handle it. We are looking at it in conjunction with our new financial management system, which will be introduced next year. It is really a way of trying to capture it in one process rather than trying to set up a subsidiary register.

Mr GEORGIU—When will it be done?

Mr Johnson—We are looking at introducing a new financial management system probably around the middle of next year. We would be hoping to try to put it in in conjunction with that new financial management system.

Mr GEORGIU—Does that mean that you may or may not?

Mr Johnson—It is our intention to try to do that with the new financial management system. If, for some reason, that was going to cause us a problem, then we would have to look at another system. We are trying to capture this as a one-stop shop, if you like, of information.

Mr GEORGIU—You sound very uncertain, if I may say so.

Mr Johnson—We are trying to do it through the financial management system.

Mr GEORGIU—Do you think that you will be able to achieve that? You sound very definite about the system’s ability to deal with this.

Mr Johnson—I do not know because I am not sure how easy it will be to capture the sort of information that we need. It is very much our hope, and we are putting that in the specifications for the design. If it is not possible, then we will have to look at some sort of

subsidiary system that would capture it. We should know whether that is possible in the next five to six months.

Mr GEORGIU—I pursue the same point regarding safe custody arrangements for documents. You have agreed to that recommendation. How have you followed it up?

Mr Johnson—We have issued guidelines on the way that documents should be stored. We have also had undertaken for us recently a major review of our security arrangements and we are putting in new security procedures following that review. We have just let a tender for that. That includes an information and training exercise for staff. But we do have rules about the sorts of cabinets that should be used, what things have to be locked up and where.

Mr GEORGIU—Do you have any idea of the degree of implementation of the guidelines?

Mr Johnson—We have spot checks every now and again which catch some people. I think it is very good, but there are instances and lapses that we have to follow up on.

CHAIR—In the audit report, health and family services is shown as having no loan guarantees, no non-loan guarantees and no letters of comfort in the financial years 1995-96 or 1996-97 but indemnities of \$888 million in 1995 and unspecified values of indemnities in 1996-97. I notice in the appendices that the only indemnities that you have listed are four against CSL and one against the Commonwealth Rehabilitation Service for work training. Is that all you have, or have you not listed them yet?

Mr Johnson—There is one additional one which is for a person that has undertaken some work for the department, which is an indemnity. What that indemnity does is give the same level of protection as for Commonwealth officers. But that is the only other one.

CHAIR—That is really the total of your indemnity. You could write it down on a piece of paper in about 20 minutes, couldn't you? Why do you have to have a central management system to capture all this stuff?

Mr Johnson—What we are trying to do is capture general information on all the contracts that we issue rather than just the issue of particular indemnities and guarantees. We have upwards of 400 contracts each year. It is broader contracts than just those covered by indemnities.

CHAIR—Let me turn the question around then. I know this is not on the table for discussion. We have already checked that out with ANAO. There is another side to this equation—that is, guarantees or indemnities that you, as departments, as purchasers, hold from suppliers or contractors or subcontractors. Do you have any of those?

Mr Johnson—I am not sure I follow what you mean.

CHAIR—You just said that you have something like some 200-odd contracts out; is that right?

Mr Johnson—Yes.

CHAIR—You are paying these contractors to do work for you. Do you have any guarantees or indemnities from them to you?

Mr Johnson—I think we normally insist that they have some sort of indemnity and that they indemnify their staff.

CHAIR—Do you have a register of those?

Mr Johnson—No. That would be picked up under our contract arrangements.

CHAIR—Do you pay them 100 per cent of every progress claim?

Mr Johnson—If the work has been satisfactory. If the delegate considers that the work has been satisfactory.

Mr GEORGIU—I am glad it wasn't on the table!

CHAIR—Can I proceed with that a little? Do you have a register with your contractors, and the contracts that you sign, of indemnities and guarantees that you hold from contractors?

Mr Collings—We have a register, essentially, of guarantees that we hold from contractors.

CHAIR—Are the instruments themselves held in a secure—

Mr Collings—The instruments are held by the respective project offices, primarily.

CHAIR—But there is a central register and they are cleared off as they are returned to the contractor?

Mr Collings—Yes.

CHAIR—Do you use those frequently?

Mr Collings—Quite commonly, particularly in our major projects.

CHAIR—That is, you write many of your contracts with a retention built into progress payments.

Mr Collings—If there are up-front payments in a contract, then we would require a guarantee as part of that, for example.

CHAIR—Fair enough. That would have been like when we paid up-front for ASC to establish the yards at Port Adelaide at North Head.

Mr Collings—Yes.

Mr Fitzgerald—In the major contract area—and I am not really sure what my colleagues are actually saying here—we have lots of indemnities or guarantees from companies in terms of things like liquidated damages on delivery, liquidated damages on AII performance, indemnities against breach of intellectual property rights, unconditional financial guarantees for moneys that we advance to a company before they give product back to us—we cover that with what we call a bank guarantee—and performance guarantees. There are a whole host of those. I am unaware that we actually keep a central register of those, but they are kept tied with contracts on particular projects. There could be dozens on any one contract for all those sorts of headings—latent defects, warranties, insurances on property and on personnel and all those sorts of things.

CHAIR—Is it good enough that they are not recorded centrally?

Mr Fitzgerald—I do not know that it would serve any purpose to us to record them centrally. Let us take a financial guarantee from a bank in terms of an advance payment. That is a schedule done under contract administration which gets liquidated over time as product is delivered to us. If we advance payments, it goes up. It is an adjustment process. Over the period of contract, certainly from start to finish, it will go up very quickly if there is an advance payment and then it will drop back down to zero again. The warranty will run on through the life of the product or to the end of the period at which we negotiate the warranty. On each of the headings, there is whatever it is that you negotiate.

Mr GEORGIU—I would like to know—because it is not my prime area—the significance of the Department of Finance circular 1997/06.

Mr Jackson—The circular was important in the sense that it gave a deal of impetus to initiatives taken by the Auditor-General in report No. 6 which identified a number of fairly comprehensive deficiencies in agencies' practices. Its main purpose was to consolidate, if you like, information, best practice and principles and to promulgate those to agencies. This happened in 1997. It was significant in the sense that it did consolidate all the available information and was addressing some real issues that the Auditor-General had raised at the time, and we developed it with the assistance of the Auditor-General's office.

Mr GEORGIU—I ask the Auditor-General's office: how important is compliance with the circular?

Mr McPhee—A copy of the circular is actually on page 74 of the report. As I recall, the circular was very much about promoting good practice and best practice in this area. As we have discussed previously, chief executives have the responsibility to manage efficiently the operations of their department, so the obligation resides with them. But Finance, in working with us to get this circular out, I think promoted what is considered to be good practice in this area, and there is no question that this circular was very instrumental in getting the improvement in public administration in this area that we have seen.

Mr GEORGIU—Could I refer you to page 37, 3.55, where the Auditor-General says:

Although agencies report a high degree of awareness of the existence of this circular, there have not been high levels of compliance with the guidelines.

Can you spell that out a bit more and just tell us: is that important?

Mr McPhee—I might ask Mr Cronin to pick up on that.

Mr Cronin—In terms of when this came out, if we go back: the last circular the department of finance put out was in 1989. We then came forward to 1997. There was a process of reform. We had not achieved actually all the aspects—like the need for contract registers, as picked up in the circular, and the authorisation process—but there have been improvements. There is just the sheer size of the Commonwealth. It varies across the Commonwealth. As the chairman mentioned, the Department of Defence had shown a marked improvement and is commented on favourably in the report on that. Other agencies were somewhat slower off the mark. That relates to the fact that some of them do not have many indemnities or guarantees. The more you have, the better you tend to be at managing them.

CHAIR—I thought it would be easy if you have only got four or five. I would have thought there was nothing to it.

Mr Cronin—One of the problems you relate to is the movement of staff. These things relate to an area. Many public servants might only ever see one of these in their lifetimes, unless they are in an area that is used to contracting—such as in Defence, which has a lot of them—where the people are experienced in them. For others, it is just part of a contract. You can see it in everything. It does vary enormously. The overall thing is that no-one had achieved best practice, but most agencies were improving.

Mr GEORGIU—With what aspect of the circular is there a low level of compliance?

Mr Bourne—I agree with what Mr Cronin said, but this business about there not being high levels of compliance is referring to things like, as on page 35, subrogation, time limits and—further down the track—things like review and evaluation. The Finance circular deals with the full gamut of these things. There was a very small minority of agencies that had done anything about including subrogation clauses in, for example, their indemnity contracts. Review and evaluation, I seem to recall, were not done particularly well. Some of the formal aspects of risk management left something to be desired. But having said that, there is no doubt that there was significant improvement in most—

Mr GEORGIU—Overall.

Mr Bourne—Yes, overall. But, in some of those areas that I have mentioned, clearly, more needed to be done.

Mr GEORGIU—Do you regard these shortfalls in compliance as being significant? I am trying to get some notion of whether low levels of compliance with much less significant things is something that needs to be picked up.

Mr Cronin—Yes. For example, the number of indemnities which are of unspecified value is a classic one. We need to have time values on the indemnities and to have financial limit values. In the back of the report there, we go on for literally pages with unspecified items. They are uncapped. What we would be looking for is time limits on these, to the extent possible, and setting of financial limits. This is where we think the process of review is very important. If agencies could go back and review these, could they actually negotiate a limit to them? Could we actually rule them off? Otherwise they sit there forever. They are the sorts of things we would like to see improvements made in.

Mr GEORGIU—Does Finance broadly agree with the Auditor-General's views on this?

Mr Jackson—To the extent that the Auditor-General's office has had the benefit of being in touch with agency practice, we have no reason to question that. If the evidence from those surveys is as it is portrayed, then we would support their conclusions, obviously.

Mr GEORGIU—Do you mind if I just switch this to Defence?

CHAIR—Go for whoever you like!

Mr GEORGIU—How do you see Defence as standing in terms of compliance with this component of the circular?

Mr Collings—In terms of subrogation?

Mr GEORGIU—Yes.

Mr Collings—We comply with it, yes. We have a chief executive instruction which requires that all indemnities include a subrogation clause. We have drafted a standard subrogation clause which our legal office has cleared, and that is available for use in all indemnities.

Mr GEORGIU—Health and aged care?

Mr Johnson—A standard contract agreement which we encourage people to use which includes those provisions. If they want to amend that, they have to get it cleared by our legal services branch.

Mr GEORGIU—Can the Auditor-General give us some notion of which departments are least compliant? There is a generalisation saying that there have not been high levels of compliance. Defence says that they are compliant. Health says that they are compliant. Who is not complying?

Mr Cronin—I guess the question relates to subrogation. It is wider than subrogation clauses. Subrogation essentially works so that the Commonwealth can step in and take over an action, which was very important, say, in the CASA indemnities. So, instead of maintaining a commercial insurance arrangement, it was found the Commonwealth was better to take that in-house, because it could actually solve problems without going through a

legal process. I think it is somewhat wider than that. It literally relates to things like the time limits and the financial limits, and it does vary. We are hoping that agencies are getting better, but it does relate to the specific matter being negotiated.

Mr GEORGIU—Can we address time limits then? Can we go through the same exercise with both Defence and Health?

Mr Collings—Again, Mr Georgiou, we have a provision within the chief executive instruction for time limits and for financial limits, and so we essentially regard ourselves as complying.

Mr GEORGIU—So you regard yourself as being fully compliant?

Mr Collings—Certainly since the time of the first ANAO audit we have put in place those requirements, and essentially we are complying with those requirements.

Mr Johnson—We have chief executive office instructions to cover those issues.

Mr GEORGIU—And they are being complied with?

Mr Johnson—Yes. As has been pointed out, we only have a very small number, so we have the opportunity to look at them every year when we do our annual review for the annual financial statements.

Mr GEORGIU—We have two major departments saying that they are compliant. Who is not complying?

Mr Cronin—I guess the way we would look at this—

Mr GEORGIU—I get very literal at times, I am sorry.

Mr Cronin—is to look at what we have at the back of the report on indemnities. The continuing list in there of unlimited or unspecified indemnities gives an indication that agencies quite frequently have all their indemnities as unspecified or unlimited by time. We would just say that, if you look down the list shown in there, you will see that under the Office of Asset Sales ‘unspecified’ is mentioned quite frequently—under the Department of Finance and Administration portfolio—and that is not unusual. Sometimes it relates to the nature of the indemnities being issued, but it is hard to distinguish whether it relates to the nature or to the negotiating period. Our premise is that the more we can actually cap these both in time and in financial limits the better the Commonwealth is able to identify its risks and manage them.

CHAIR—Can I just follow up on that. As agencies move to centralised registers of these instruments, are we going to wind up with the problem that they fail to delete them when they are no longer in effect?

Mr Cronin—Unless you review them, yes, you would.

CHAIR—Did you find any evidence of that during this audit?

Mr Cronin—We found evidence, particularly in the previous audit, where instruments relating to an assets sale had been issued for which the Commonwealth had no record. When the other side produced a piece of paper which amounted to a guarantee, the Commonwealth had to pay tens of millions of dollars to extract that from them for the asset sale to proceed. It was simply that we did not have a record and so we had no idea what was going on. I do not know whether it would have changed our overall approach to the sale, but the other party was sitting there with a piece of paper and it cost us a lot of money to actually extinguish the guarantee.

We need to record and to review the process. That is why we made recommendations on both aspects in this report and in the previous report. Agencies always need to watch this and to improve this—to record the transaction and to review it. I think that is part of good administrative process.

CHAIR—Without any question; that is self-evident, I would have thought, from many years ago. The penny should have dropped with the first one that ever happened.

Mr GEORGIU—In terms of compliance, what is Finance's relationship with the Office of Asset Sales?

Mr Cochrane—The Office of Asset Sales is part of the agency portfolio. It is basically a stand-alone agency. For reporting purposes, it is part of the minister for finance's responsibility.

Mr GEORGIU—Do they enjoy a reasonable degree of autonomy?

Mr Cochrane—Yes, they are basically autonomous.

Mr GEORGIU—Has Finance sought up-to-date statements from all agencies, in terms of guarantees and indemnities of letters of comfort?

Mr Jackson—Do you mean within the portfolio?

Mr GEORGIU—Yes, within the portfolio.

Mr Cochrane—Each year when we do the audit we require each of the agencies to bring the registers up to the standard required as per the latest audit report.

Mr GEORGIU—Does that cover the Office of Asset Sales?

Mr Cochrane—Yes.

Mr GEORGIU—So they are complying with what you—

Mr Cochrane—With the obvious exceptions to the comments in the report, although this year this audit report covered the 1997-98 period and we have not had the year end for

1998-99 year. The improvement will be measured when we do the financial statements this year.

CHAIR—It would be pretty hard to have it since the year is not over yet.

Mr Cochrane—Yes, that is right.

Mr GEORGIU—My impression from listening to audit is that you are broadly happy with the way that things are moving. You would like to move a little bit more in some areas. Are there any particularly sensitive areas that you think there is not sufficient movement?

Mr Cronin—From where we started, it is like a quantum jump. If we went back to 1996, it was fairly astonishing what we were uncovering as we went through: no inventories, lost documentation, very poor management, and, essentially, something was often given to low level staff who often had frequent turnover to look after. We often find now in agencies that there is a high degree at senior management of knowledge and understanding. The whole process of documentation has improved. Yes, there is a continuing need for improvement in certain aspects but we have come a long way and we think that this process is continuing. When we look at the budget strategy in Budget Paper No. 1 where we see the recording of Commonwealth risks, we have come a long way since 1996 when we started the audit.

Mr GEORGIU—Is that broadly the view of the Department for Finance and Administration?

Mr Cochrane—Yes.

Mr GEORGIU—Have there been any notable pockets of resistance?

Mr Cochrane—Not that I am aware of. Agencies, on the whole, agreed with the recommendations in the report. Mention has been made that we agree with qualifications but I think that relates to the nature of the agency which put that forward, in terms of Defence, which we accepted. I think it is quite a positive outcome from the audit.

Mr McPhee—The other thing I would say is that the discipline of the new legislation puts responsibility clearly on CEOs as well as the financial reporting requirements that Mr Cochrane has referred to. Their agencies have to formally report in their financial statements and these instruments help considerably to tighten up the process because secretaries, at the end of the day, have to actually sign off on the financial accounts as well. It is a good reason for them to take some interest in this area.

CHAIR—Does DOFA still have an administrative role in this area?

Mr Jackson—In the whole of government area?

CHAIR—Yes.

Mr Jackson—Yes.

CHAIR—Previously the committee recommended that DOFA should seek up-to-date statements from all agencies with guarantees, indemnities, letters of comfort within their portfolio and the steps they have taken to address each relevant recommendation. Has all that happened?

Mr Jackson—We provided a comprehensive report in the Finance minute of the last JCPA report, No. 360. We have not taken any other follow-up action since that time. We are aware that the Auditor-General's office has been conducting its own survey, but we have not done anything independently of that.

CHAIR—Mr Cronin reported incidents in the past where an indemnity had evidently been issued but we did not have either a record or a copy of the indemnity, but it came back to bite us. What is the risk of that occurring today?

Mr Jackson—To the extent that the general overview of the Auditor-General's report is, in their own words, positive, we conclude that the risk is low. Nonetheless, to the extent that there is an awareness in agencies, but there is no systematic and comprehensive compliance with all the sets of principles, there are some risks of that occurring.

Mr McPhee—I would endorse what Mr Jackson said. There are no guarantees in this area that there are not ones which escaped the net but, certainly, the awareness is much higher.

CHAIR—You said there was not 100 per cent compliance. If we ask you for a league table or a scorecard, would you give that to us? Would that be a reasonable thing to ask for?

Mr Jackson—It depends on the time that the committee gave us to provide that feedback.

CHAIR—Part of that has to do with whether it is worth the effort. Is it worth the cost to do it?

Mr GEORGIU—There is a reasonable consensus. I think we are happy with that.

Mr Jackson—I would question if it is worth the effort in a comprehensive way.

CHAIR—Then we will not ask you for it.

Mr GEORGIU—What does happen when someone leaps out of the woodwork and says, 'By the way, you have an unregistered indemnity here which you are going to have to pay'? What happens in that circumstance?

Mr McPhee—That question is for Finance. If there is a significant amount of money involved and the department does not have funding to meet the costs then, obviously, it becomes a budgetary issue.

Mr Cochrane—The residual issues from sales are basically the responsibility of Finance and Administration. In each case, we would make an application for funds if one of these came to fruition. It has not happened yet.

Mr GEORGIU—I am more interested in this issue: if you were supposed to have registered this, then how come we did not know about it? You are now calling it up without us knowing about its existence.

Mr Cochrane—As in the example that was mentioned before?

Mr GEORGIU—Yes.

Mr Cochrane—I am unaware of that example.

Mr McPhee—My experience would suggest that Finance would be looking for an offset from somewhere else.

CHAIR—I would have thought that they would be looking for a head!

Mr McPhee—As well as a head.

Mr GEORGIU—In terms of compliance, because I am interested in that, has it dawned on departments that if they come up with an unknown guarantee that there will be some costs associated with it as a way of encouraging the others? Do CEOs know and disseminate that?

Mr McPhee—I think it is pretty well understood around agencies that with that sort of thing the minister, in the first place, would be expected to look around and provide offsets. Obviously, the significance of the amount would come into play: if it could not be absorbed without a significant impact on a particular program, then it becomes a government issue.

Mr GEORGIU—But, generally, you are not happy about it?

Mr McPhee—Yes.

Mr Cochrane—Yes.

CHAIR—Are all these off balance sheet contingent liabilities now winding up in the annual financial statements of each department?

Mr Cochrane—Yes, they are.

CHAIR—Are there any more questions?

Mr GEORGIU—We are both pleased and distressed that it actually seems to be going well!

CHAIR—On behalf of the committee, may I say well done and keep it up. Thank you. It is good to know that the committee's earlier work has helped to yield a positive result.

Resolved (on motion by **Mr Georgiou**):

That this committee authorises publication, including publication on the parliamentary database, of the proof transcript of the evidence given before it at public hearing this day.

Committee adjourned at 2.50 p.m.

