COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

Reference: Review of Auditor-General's Reports second quarter 1999-2000

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JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

Tuesday, 16 May 2000

Members: Mr Charles *(Chair)*, Mr Cox *(Deputy Chair)*, Senators Coonan, Faulkner, Gibson, Hogg, Murray and Watson and Mr Andrews, Mr Georgiou, Ms Gillard, Mr Lindsay, Mr St Clair, Mr Somlyay, Mr Tanner and Mr Kelvin Thomson

Senators and members in attendance: Senator Gibson and Senator Murray and Mr Charles, Mr Cox and Ms Gillard

Terms of reference for the inquiry:

Review of Auditor-General's reports second quarter 1999-2000.

WITNESSES

Committee met at 11.01 a.m.

ALLEN, Mr Michael James, Chief Executive Officer, Australian Office of Financial Management

BATTELLINO, Mr Ric, Assistant Governor, Financial Markets, Reserve Bank of Australia

BOYD, Mr Brian Thomas, Senior Director, Performance Audit, Australian National Audit Office

CAMPBELL, Mr Francis, Head, Domestic Markets Department, Reserve Bank of Australia

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

HAMMOND, Mr Peter Anthony, Acting Manager, Debt Finances Unit, Australian Office of Financial Management

JOHNSON, Mr Andrew Mark, Manager, Portfolio Research Unit, Australian Office of Financial Management

KAUFMANN, Mr Brett Andrew, Executive Director, Australian National Audit Office

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

McCRAY, Mr Peter Anthony, Deputy Chief Executive Officer, Australian Office of Financial Management

WALKER, Ms Caroline Rosemary, Manager, Debt Policy Unit, Australian Office of Financial Management

CHAIRMAN—I now open today's public hearing, which is the second in a series of hearings to examine reports tabled by the Auditor-General in the financial year 1999-2000. This morning we will be taking evidence on two audit reports—namely, Audit report No. 14, 1999-2000: *Commonwealth Debt Management* and Audit report No. 24, 1999-2000: *Commonwealth Management and Regulation of Plasma Fractionation*. The committee has received submissions from the Reserve Bank of Australia and the Department of Health and Aged Care in relation to Audit reports Nos 14 and 24 respectively.

We will be running today's sessions for each report in a format that allows all relevant participants to be present to hear what others are saying about the Auditor-General's report. I must ask participants to strictly 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 for discussion, I would 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, given the length of the program, statements and comments by witnesses should be relevant and succinct—and I underline the word ‘succinct’. 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 the proceedings of the committee. Copies of the committee’s statement are available from secretariat staff. The Audit report now being considered in this session is Audit report No. 14 1999-2000: *Commonwealth Debt Management*.

I now welcome representatives of the Australian National Audit Office, the Australian Office of Financial Management and the Reserve Bank of Australia to today’s hearing. We have convened today’s public hearing to examine the main issues raised in Audit report No. 14, 1999-2000: *Commonwealth Debt Management*. Does Mr Allen wish to make a brief opening statement—and I underline the word ‘brief’—before the committee asks questions?

Mr Allen—I joined the Australian Office of Financial Management on 22 March this year. I have read the report. I agree with the recommendations that have been made in the report and am currently working with management to resolve outstanding issues, some with a short-term and some with a medium-term perspective. We have worked within our office to establish an audit committee and to review these issues as part of that process. We continually monitor outstanding issues with respect to the report and we would be happy to discuss in detail some of the actions that we have taken to address the issues that have been raised in the report.

CHAIRMAN—Thank you, Mr Allen. Does Mr Battellino have a brief opening statement?

Mr Battellino—Only to say that we have read the report, obviously; and, like the Treasury and AOFM, we agree with most recommendations there.

CHAIRMAN—Thank you. Mr McPhee.

Mr McPhee—Just briefly, if I may recap on the audit findings or recommendations, we identified a number of areas where improvements could be made to the risk management and control environment for the Commonwealth’s reducing but still significant debt portfolio. The areas where we felt improvement was required were in the continued examination of the merits of increasing the Commonwealth’s foreign currency risk exposure above the level necessary to fund expenditure, and a re-examination of all benchmark portfolio targets as part of the next portfolio management consultancy. Secondly, there should be continuous management reporting and disclosure of performance against targets and, finally, improvements to the control framework for the Commonwealth swap program, including regular examination of compliance with operational procedures, improved procedures for derivative dealing activities, and better management of market risk—given the significant exposure that the swap book represents. We made six recommendations, all of which were agreed by the Australian Office of Financial Management and endorsed by the Treasury.

CHAIRMAN—Thank you for that, gentlemen. Mr Allen, considering the Audit report and our discussions we have had privately with ANAO to which you were not privy, one of the things that concerns me is that we are playing with very large dollar values here. I use the word ‘play’ advisedly. In a sense it is a game, isn’t it, because there are huge risks involved? The first question is this: do we pay our officers enough to be far enough ahead of the game to be taking these kinds of risks—as compared, for instance, to a bank?

Mr Allen—My appointment highlights the move by Treasury to be able to introduce new skills into the office, with a strategy to then improve and have skills available to manage the portfolio consistent with commercial best practice. The process of my employment is consistent with that approach. I have a background in financial markets and have worked with investment banks, banks and the Treasury Corporation of Victoria, which is an organisation which has similar objectives to the office. Ongoing, we will be addressing our need to be able to introduce new commercial skills to our organisation, in line with the development of our business and of our strategic debt management plans. That is certainly a major emphasis of the brief I have joined the organisation with.

CHAIRMAN—You are bypassing the question, with respect. You do not have to tell me what your salary is; I can certainly find out. What I am interested in is the relationship between what the Commonwealth pays you and what the National Bank would pay a similarly responsible senior individual.

Mr Allen—Suffice to say, it is moving in the right direction.

CHAIRMAN—It is moving in the right direction; it is coming up from 10 per cent to 15 per cent?

Mr Allen—I think we have the capacity to take on the appropriate commercial skills and that we have been given a mandate to—

CHAIRMAN—I am not getting the answer. So we will seek it another way, I suppose. That is easy enough to do.

Mr Allen—In terms of my salary arrangements?

CHAIRMAN—Yes.

Mr Allen—Obviously, my arrangements have been negotiated under the standard AWA arrangements. I would be happy to discuss those with you.

CHAIRMAN—Let us move on. As in recent times our dollar has fallen rather dramatically, do we keep a count daily of the kind of exposure that we have with foreign currency exchange, considering the falling value of the dollar?

Mr Allen—Yes. Our exposures are monitored and reported. We have a structure within the organisation where we have a benchmark, which is a critical risk management tool and has been agreed to by external investment banks and also by Treasury. There has been a process by which that benchmark has been determined. We then report our exposures against that benchmark. I would be happy to discuss the detail of that with you, but it is consistent with practices that one would see in the private sector where those exposures are reported. We report formally on a biweekly basis and exposures are monitored on an ongoing basis at all times.

Senator GIBSON—Given that the Commonwealth's debt has come down substantially in the last few years and is getting down towards half of what it was, given that our exposure to US currency was less than one billion at the reporting date for this report and given that over the last few years the 10-year bond rate differential between the US and Australia has come down from 250 basis points to 30, down towards zero in more recent times, why do we still have this benchmark of 10 to 15 per cent exposure to the US currency?

Mr Allen—Perhaps I can give you an overview, and I will ask Mr McCray to give you some further background. It is important from a debt management perspective that, as a management group, we have a benchmark within which we ensure that our risks are maintained. That benchmarking process is subject to review on an ongoing basis. So over time, as we have done over the years, that benchmarking and the relevance of that benchmark process will be reviewed. At the moment, for us to make a decision to move away from that benchmark, as a management team, would introduce risks that we are currently not delegated to execute. So, from a risk management perspective, the key issue within the office is to ensure that at all times we manage our risk consistent with the benchmark and then run independent reviews over time to see that the benchmark is changed to be consistent with our current requirements.

Senator GIBSON—The 10-year bond rate differential has been down for over three years. Why do we still have the same benchmark?

Mr Allen—The appropriate review process has not been undertaken as yet but, as indicated in the report, we are intending to undertake that review. Any appropriate recommendations in terms of changing the benchmark will be put to our board and from there it will be put to the Treasurer for approval.

Mr COX—The dollar has been down below 60c twice since the benchmark was set. It seems to be slow learning to me to have not adjusted it.

Mr McCray—The critical point with the benchmark is that it is not based, and never has been, on exchange rate views or interest rate views. It is a long-term benchmark grounded in long-term structural relationships between interest rates and exchange rates and correlations and volatilities between relevant financial variables. If we were to say, 'The currency is below 60c: we had better change our benchmark,' we would be doing exactly the wrong thing. We would be taking views on the currency: we would be punting on the currency. It is the antithesis of what we are about in managing to a benchmark. The whole nature of managing portfolios to benchmarks is that the benchmarks need to be established on a very rigorous basis and signed off at a very senior level, but then they do not change day to day, week to week, month to month. Typically, benchmarks ought to be reviewed on a four- or five-year cycle, and that is where we are at at the moment.

Mr COX—We are now talking about four or five years since the benchmark was set. I have read the section on page 44 of the report under ‘Portfolio management’ which reads:

Treasury’s debt management objective is to raise, manage and retire Commonwealth debt at the lowest possible long-term cost, consistent with an acceptable degree of risk exposure.

The Commonwealth’s debt management decisions can have a significant effect on financial market confidence as well as overall financial stability because of: the relative size of the Commonwealth debt portfolio ... Accordingly, Treasury is obliged to forgo the potential short-term gains associated with exploitation of its relative size advantage in favour of the longer term benefits of market confidence, liquidity and lower funding costs that accrue to responsible management. The Commonwealth government in its policy setting role has the capacity to directly influence key financial market prices. For this reason, Treasury has adopted an approach to debt management that is not reliant or seen to be reliant on taking views about future direction of interest rates.

I agree with that. I think your job is fairly straightforward: it is to raise debt at the lowest possible cost with an acceptable degree of risk for the Commonwealth. But it seems that four or five years have gone by and the Commonwealth has been exposed to nothing but exchange rate risks for what, as Senator Gibson describes, are very small returns.

Mr McCray—Taking the long view, the strategy of maintaining a discretionary level of US dollar exposure has realised very substantial savings for the taxpayer. That is not to say that we are indifferent to what is happening in financial markets. The benchmark is under review as we speak, having reached that four- to five-year period, with a number of other variables influencing that position, including the move to accrual budgeting and the government’s strategy of reducing and eliminating net debt.

I should say that, of itself, a large reduction in the interest rate differential between, say, US Treasury 10-year bond yields and Australian 10-year bond yields does not prove that the benchmark is wrong. The benchmark US dollar exposure, in essence, is grounded in the failure of the uncovered interest parity theory and is essentially based on the notion that there is a systematic bias in the relationship between Australian dollar and US dollar interest rates.

Essentially, we are saying that the Australian dollar historically depreciates less than the US dollar-Australian dollar interest differential implies. When that interest differential goes to zero, it is certainly a signal that you want to re-evaluate—that is the strategy and the thinking underpinning the strategy—but if you think of the interest differential as reflecting two components, some sort of risk premium as well as a view on the exchange rate, then you could have a zero interest differential and declining currency but still a positive structural exchange rate bias. It is merely a signal from the market that they are expecting the Australian dollar to appreciate over some sort of longer term period. If you look back over the last couple of years at some sort of consensus market view of where the currency is heading over the next 12 to 18 months, then typically they are looking at an appreciation.

Senator GIBSON—I understand that. The report clearly shows in figure 5.2 on page 100 that the Commonwealth has been a beneficiary to the extent of $500-odd million over the 12-year period. However, when you look at that table, there are two big lumps in it: the 1995-96 realisation of a gain $1.3 billion and then the 1997-98 realisation of a loss of $2 billion. I would like to have some understanding of what is behind those big movements relative to the $200 to $300-odd or relatively small amounts year by year for the other years.

Mr McCray—I think it is probably fair to suggest that large movements in the currency in those years are probably the primary determinant of those movements.

Senator GIBSON—Is there a more detailed explanation that you would like to come back to us with?

Mr McCray—As we have discussed already, the currency did depreciate quite sharply through the course of 1997-98. I dare say that would be the very major explanator of that $2 billion economic loss in 1997-98. The economic loss is a valid indicator of the economic position of the portfolio—the economic outcome, if you like—but it is important to look at the components of that economic gain or loss. There is a realised position and then there is an unrealised position, which is simply the shift in the market value of the portfolio.

From our perspective, where we are not taking views on currency, we are not seeking to make short-term trading profits by predicting the course of the currency over the short-term period, the movements in the market value are perhaps not quite as significant as they would be for, say, an investment bank that was looking to make profits on that basis. They are not realised; they have no impact on the bottom line. The significance of them really is a signal to portfolio managers to say, ‘The strategy is not panning out quite as you might have expected based on the long-term view. Re-evaluate your strategy. Are you still comfortable with it?’ Through the course of 1997-98—in fact four or five times over the last three years—we did quite a detailed re-evaluation of the strategy that includes a discretionary level of US dollars in the portfolio, and the conclusion of each of those reviews has been that we, and those to whom we report, have been satisfied that there is still a basis to believe there is a structural bias in the interest differential between Australian dollar and US dollar exchange rates which warrants a continued discretionary US dollar exposure. As I say, we are reviewing the benchmark currently—again testing that proposition and again mindful of some of the major changes in the environment in which we operate since the original recommendation in favour of US dollars.

CHAIRMAN—It really bothers me that you operate under a recommendation to target foreign currency exposure of somewhere between 10 and 15 per cent, and that has been, as I understand it, since August 1988. Forget about politics, but the government is reducing primary debt. Doesn’t that mean that, while our dollar is now exposed at almost historically low levels, you are going to have to close some of that out and bring forth at this date unrealised losses? Isn’t there a very real risk of significant exposure?

Mr McCray—The swap book has a profile of maturities that runs over 10 years. As it happens, the profile of maturities over the next 18 months to two years is quite modest. But swap exposure is rolling off, nonetheless. So, as the portfolio is shrinking, so too is the US dollar exposure, on the basis that we are not undertaking any new currency swaps at the moment. At the moment the projected decline in the net debt position is not completely at odds with the projected decline implied by the maturity profile of the swap book. In other words, there is not a huge position which will have to be liquidated over the next 18 months and realise those losses.

Mr Allen—To add some further background, your issue in terms of the currency exposure is obviously a portion of the total portfolio. In regard to your comment with respect of the downsizing of our liability portfolio, the way in which from a commercial perspective we manage that risk is that we are reducing our total liability exposure, not just the currency exposure. So certainly there will be a repayment or a run-down of our currency exposure. But, on that argument of the original yields that we issued the liability at over past years and we may be halfway through the issue of a 10-year bond and we do get surplus proceeds which are made available for debt retirement, there is an issue of what is the current market value and what was the original issue yield. And, to the extent to which you recognise that issue for currency losses, that can also be applied to our physical liability portfolio in the domestic fixed interest markets as well.

CHAIRMAN—But if we bought at 80c and we are selling at 57c, do we have a bit of a problem, or have I missed something somewhere? I am not an accountant; I am a simple engineer.

Mr Allen—From our side, these issues are complex in detail, but in terms of the macro issue we are repaying liabilities of the Commonwealth. As Peter McCray has explained, the approach that the Commonwealth has taken over the years has been to try to achieve a diversified exposure to its interest expense, which has included the allocation of some of that liability expense to currency. On repayment, the isolation just to the currency exposure ignores the way in which the portfolio has been developed. The portfolio has been developed under a diversified approach, inclusive of both currency and interest rate risk, so what we are repaying is effectively both. Certainly currency levels at the moment are quite different from the levels that these transactions were originally opened at, but it is part of a diversified approach. As Peter has explained, we are not in the business of actually trying to pick at which point we should be raising foreign currency liabilities, nor are we trying to pick at which point specifically we actually try to repay liabilities. We are not taking market views, and that is obviously a very important issue from the perspective of the government's position in terms of financial markets and the way in which it manages risk. We are not an investment bank which is trying to take risk; we are trying to minimise the impact of market volatility on our interest expense and debt service costs over the long term.

Mr COX—Do you think it is likely that as a result of your present review you may change the benchmark to give you less exposure to US dollar exchange rate risk?

Mr Allen—When you look at some of the charts in the early part of the report and see the quite extensive increase in debt over the periods of the nineties and when this benchmarking concept was developed to where we are currently where we are obviously at quite a dramatic reduction in debt outstandings, I think that this review process will indicate quite a different approach to the benchmark to what we currently have. But that is consistent with the changing nature of the government's finances.

Mr COX—More or less US dollar exposure?

Mr Allen—I would not like to pre-empt what that review process may lead to. Quite possibly it will be less, but that is also in the context of a significantly reduced call on financial markets for debt as well.

Mr COX—On that significantly reduced call, on page 67 of the auditor's report—and I notice that Mr McPhee has signed the thing off on 12 October, before he had seen either the mid-year economic and fiscal outlook or the budget—he says:

> The Government's medium-term fiscal target is to halve the ratio of Commonwealth general government net debt to Gross Domestic Product from almost 20 per cent in 1995-96 to 10 per cent by 2000-01. The 1999-2000 Budget estimates that this will be achieved (see Figure 4.2), although this is dependent on the fulfilment of a number of assumptions including the full privatisation of Telstra.

Would Treasury now agree that, in the light of the 2000-01 budget, if those estimates are accurate it will not be necessary to have the full privatisation of Telstra to achieve that debt target?

Mr Allen—We are obviously working to position the portfolio and our risk management strategies to be consistent with government policy objectives. Obviously, the risk from a financial management perspective of actual versus forecast is a risk that we have to manage and maintain strategies for which will enable us to manage the outcome where forecasts are not translated into actual.

Mr COX—So you think there is some risk that the estimates in the budget will not be achieved and that net debt will not be reduced from about $96 billion to $47.4 billion by the end of the coming financial year?

Mr McCray—It is probably fair to say that they are risks that we are not qualified to discuss. Our task is to manage the portfolio and to undertake the funding and debt management transactions that follow.

Mr COX—Are those the Treasurer's estimates, and not Treasury's?

Mr McCray—You would really need to address that to our colleagues in the fiscal policy area of Treasury. I am merely saying that I do not think we are qualified to express a view on that particular point.

Ms GILLARD—I have some questions on a slightly different topic, but they do relate to asset sales. Obviously, one of the big ways in which debt has been retired is through asset sales. The report in paragraph 4.33 on page 80 talks about difficulties in the information flow between Treasury and the Office of Assets Sales and IT Outsourcing during T1, the first Telstra privatisation. I am interested in what explains that problem with information flow, where Treasury clearly had one view about the nature of the information coming to it and OASITO had a view that it was just providing information on demand. I am interested in your general comments about that and then I have some specific questions on what information was provided.

Mr McCray—Over the last two or three years there has been a very substantial improvement in the accuracy of the daily cash forecast that underpinned the Commonwealth's cash management activities. There is no requirement on the part of agencies to provide forecasts of their cash flows to the Treasury, or now the AOFM, to assist us to undertake our cash management operations. The whole framework is based on voluntary provision of detail and checking of that detail by us in conjunction with relevant agencies. That framework has been tightened up very significantly over the last two to three years and it is far more efficient. Nonetheless, we continue to look for further improvements in that framework. I would say, on looking back to that 1997 exercise, that at the margin there was certainly scope for better-quality and more timely information from the Office of Assets Sales. They might argue, as they have here, that we might have expressed our requirements in that regard a little more explicitly to them. Wherever the balance of those outcomes is—and I can imagine that you can guess where we would see the balance—the flow of information is now very effective and there were no such difficulties with the Telstra 2 proceeds. We had a number of meetings with the Office of Assets Sales and received very full and timely information from them.

Ms GILLARD— I understand one of the problems with T1 was late banking of retail application moneys by OASITO. Is that right?

Mr McCray—Again, I am not sure I am really qualified to speak on that. The relationship between the Office of Assets Sales and the bank that was employed to manage that process is something which occurred somewhat removed from our operations. Our role in this process was to try to obtain accurate daily forecasts of what cash flows would impact on the Commonwealth's public account at the Reserve Bank.

Ms GILLARD—It is my understanding that there was a problem with late banking of retail application moneys and that that did have an impact on your work in the sense that it impacted the repurchase dates of some fixed coupon bonds. Is that right or not right? What I am really trying to get to is what was the cost to the Commonwealth of matters which are on the public record at this stage—problems with late banking and also problems with a lack of advisement to Treasury about return of oversubscriptions. Those two issues have been publicly ventilated before and did obviously impact on the amount of money you had on hand at any one time. Obviously, consequences flow from there being differences in the amount of money that you have on hand. Given the cash value of the T1 sales, we are talking about fairly big lumps of money.

Mr McCray—My recollection is that certainly there was some volatility between projected cash flows and actual cash flows on a day-to-day basis. My memory does not extend to precisely the reasons for that volatility, but we would be happy to look into that further for you.

Ms GILLARD—All right. If you could look into that further, I would be interested in your confirming that the problems with the late banking of T1 moneys caused an early repurchase of $1.8 billion worth of January 1998 fixed coupon bonds to be postponed until sufficient applications were processed to fund the repurchase.

Mr McCray—We will certainly look into that.

Ms GILLARD—Thank you.

Senator GIBSON— Mr Allen, could you outline for us the timetable and what external expertise you would expect to bring in to go through the process of looking at the benchmark again?

Mr Allen—Certainly. The process of reviewing the benchmark is running concurrently with the review of the existing debt management strategy. The debt management strategy is attempting to address the challenges and risks associated with managing the government's portfolio over the short- to medium-term horizon. There are a number objectives that we are trying to meet, certainly in terms of financial market liquidity of our benchmark lines, which have been indicated by the Treasurer in the budget statements. The benchmarking process will be reviewed as part of that and we are hoping to be able to at least outline some of the broad parameters of that strategy review by the middle of the year and to be able to achieve the approval of our advisory board as well as the Treasurer for those broad issues. Part of that recommendation will be a broader recommendation to review the actual benchmark so that it is consistent with our requirements going forward, consistent with practice adopted previously. We will conduct a tender to invite people from the marketplace to come and analyse and review our benchmarking process. That could reasonably be expected to take from a couple of months to less than six months. So that time line would suggest that we would have a new benchmark in place by the latter part of this calendar year.

Senator GIBSON—I would like to know the value of your current portfolio. How is that influenced by, say, a one cent move in the Australian dollar or US dollar, either up or down and also, say, a half a per cent interest rates change here? Could you come back to us with some estimates about that?

Mr Allen—Andrew Johnson may be able to give you some views on what those exposures are.

Mr Johnson—I must admit we have calculated this, but it does not come to mind immediately. In fact, I have provided this data to Colin and his team. For interest rates, for example, the one figure that sticks in my head is about $600 million per percentage point, but I would like to confirm that; I cannot give you a precise value.

Senator GIBSON—I would be happy if you would come back to us.

Mr Allen—It is obviously dependent on the size of the portfolio.

Senator GIBSON—Sure, I understand that. Would you set out some numbers about that so we could have a bit of a feel for it?

Mr Allen—Certainly, I would be pleased to do that.

Mr COX—I wish to follow up the issue that Julia Gillard raised about the information that you receive that helps you time elements of debt management strategy efficiently. I have been having a look at asset sales in the budget, I have been looking at the general government sector cash flow statement, and I have found a little anomaly. If you have information in this area, you might be able to help me with this. I refer to the 1999-2000 net cash flows from investments in financial assets for policy purposes, which I think includes repayments by the states. The items that I know might go to make up that figure include the $9.8 billion figure for Telstra, a $741 million repayments by the states, which I think I got from Budget Paper No. 3, and an amount of $346.8 million as the proceeds for the sale of ADI Ltd. That all adds up to $10.8878 billion, yet the number that is in the budget papers is only $9.385 billion, so somewhere there is a negative number that has consumed $1½ billion. Similarly, next year there is a figure of $1.68 billion reported in the budget. The components that I know would go to make that up would be equity from the second instalment of Telstra 2 of probably more than $6.3 billion, probably another $700 million or so from repayments of debt by the states, and perhaps the proceeds from the sale of the Australian Technology Group and the National Rail Corporation. So there is a negative number that is somewhere included in that of $2 billion. I just wonder whether you can throw any light on that.

Mr McCray—You would already know that these are matters for our fiscal policy colleagues. I have no knowledge of that particular aggregate or of the numbers.

Mr COX—Would you be able to take that on notice and get an answer from them as to the elements that make up those two figures?

Mr McCray—I will certainly seek their comments.

CHAIRMAN—Mr Battellino, could you tell us how the Reserve Bank assures effective control of procedures for derivatives in terms of aggregate segregation duties, risk management monitoring and management reporting?

Mr Battellino—The first point to make is that we do not treat derivatives any differently from physical investments. They are all subject to the same rules. The rules start off with having a very clear idea of what the bank wants to do in terms of its investment strategy and defining what sort of risk the bank is prepared to accept. Within that, we have a benchmark and the governor then delegates trading in the ranges that he is prepared to allow the staff to undertake. Derivatives are encompassed within that, so it does not matter whether we do transactions in physical securities or derivatives; it all comes in that same framework. As part of that investments strategy, we obviously have to have very good systems in terms of both the structure of staff—to make sure that the front office, back office and middle office staff are separated and have clear duties—in terms of information flows and computers, to make sure we get continuous feeds of prices. So systems are an integral part of the risk management process to make sure that they prevent any fraud or anything like that. As I say, the derivatives are not treated any differently from physical transactions and they are all encompassed within an overall framework.

CHAIRMAN—Would the kind of people who are employed in your currency operations have similar rates of pay to those in the private marketplace?

Mr Battellino—No, well below.

CHAIRMAN—They are well below?

Mr Battellino—Yes.

CHAIRMAN—How do you the obtain the expertise that you need to compete against other commercials?

Mr Battellino—I suppose the short answer is that the quality of the work at the bank would be found to be very attractive by some people. So, even though their rates of pay might be less than other people might get in the market, they would see other advantages in terms of the quality of the work. Every year the bank hires a stream of graduates, maybe 20 to 30 a year. We target the top honours graduates in economics and finance essentially. Out of that pool we tend to keep some very good people because they are attracted to the quality of the work. We send some of those off to study overseas to further their education in finance and economics. So all in all I do not think the bank has a problem retaining good people at the moment.

Mr COX—Do you think the same argument applies to Treasury?

Mr Battellino—I cannot speak for Treasury. I am not sure what the arrangements are there. Through the 1980s and 1990s my impression is that Treasury suffered more of a brain drain than the bank did. I have not sat down and compared the figures, but that is my impression.

Mr COX—But there are quality people who are prepared to work for public sector pay rates, aren't there?

Mr Battellino—I am sure there are.

Senator MURRAY—There are just two short areas of discussion I want to expose. Mr Allen, is your review going to require that future benchmarks have a trigger mechanism for further reviews? In other words, what we are dealing with here is a fluid, volatile, vulnerable market situation set against a very fixed benchmark which has been established for many years. In my view you need to know what the triggers are for when the next review should occur. It cannot just be forecast to be a three-year or five-year or 10-year review; it has to happen after a certain number of events. You made the clear point in responding to the chair's question that you did not, until recently, have delegated authority to review. My belief is that people such as yourself should have automatic triggers for appropriate review. Will the review process include a trigger mechanism for future reviews?

Mr Allen—Speaking about the potential for that process to occur, I think there have been some positive developments with the formation of the office, along with the requirement to actually have an advisory board as part of that process, which then makes this framework consistent with a commercial framework. The commercial approach would be to review these benchmarks on a regular basis. The practice that is commonly adopted in the commercial sector is one which we will endeavour to adopt within the corporate governance structure of the office, and that is that all of these issues be reviewed on a regular basis and must be presented to our advisory board, with appropriate recommendations as to whether this is an issue that we need to address in terms of changing market circumstances or whether this is an issue that we may leave in place for a further 12 months and come back and review again.

Senator MURRAY—The old-fashioned approach was that regular review meant on a certain calendar basis. It was a time orientated review, whereas continuous management requires review when certain events are congruent. That is really what I am more focused on.

Mr Allen—I think that would be part of that corporate governance framework: as required, either management would address the issue or the advisory board would request management to address the issue so that it is a dynamic review process. When you are looking at the practices of the commercial sector, that is very much a part of that process, where risks are monitored on a dynamic basis and then there is the appropriate process undertaken, where the weaknesses with the current approach are clearly identified, documented and then presented to the board for a formal sign-off from them, which management can then go and actually execute in the marketplace. Yes, I agree with the view that it has to be a dynamic approach.

Senator MURRAY—My second line of questioning relates to the same kind of field and is both to the RBA and to the Office of Financial Management. Is either of you including in your processes for review and evaluation the term ‘scenario planning’? Typically, your organisations are focused on forecast estimates, market appraisals and so on, but scenario planning entails the bringing together of expertise to indicate likely scenario streams from which you develop a policy response. It is quite different from the traditional forecasting approach, and many major corporations worldwide do just that. There is a pool of several hundred experts in a wide range of areas who feed in for these scenario planning prospects.

The reason I raise this again is that the nature of markets and where they are moving and the nature of risk require an appraisal not so much in terms of contingency—although that is important—but in terms of a reaction to a prescribed set of events if they were to occur over the medium to longer term. That is the specific question: in continuous review, is there a scenario planning perspective or is there intended to be a scenario planning perspective, Mr Battellino?

Mr Battellino—The first point I would make, to make sure there is no confusion, is that, in terms of debt management, that is Treasury’s responsibility and the bank is not directly involved. To the extent that we are engaged in management, it is for our own portfolio of assets. In that respect we would regard an activity which you could say was scenario planning as part of our reserves management operations. We are continuously looking at and assessing how different currencies and interest rates might move around the world and how different markets are developing, so that we can see whether we should be switching to new markets or whatever. We are continually doing that on an ongoing basis at the bank, so my answer would be, yes, we do do that.

Senator MURRAY—The specific professional aspect of scenario planning is the input of outside expertise, because no one organisation can ever capture broad perspectives. In both your situations, you are required to have a world perspective as opposed to an Australian perspective. Does that occur?

Mr Battellino—I have to say that I myself am rather sceptical of some of the experts you get in from outside. Having said that, though, the bank does have a lot of interaction with other central banks, with investment banks around the world. We do do that. We do not pay, but have regular ongoing advice from investment banks and all sorts of things around the world, as well as being continually in touch with central banks from other countries. As far as I am concerned, paying for services from some of these people, consultants outside, is not terribly cost effective.

Senator MURRAY—Do you have large experience of doing that? You have paid numbers of them and you have had their reports and you have found them to be faulty?

Mr Battellino—I go back to the experience we had when we reviewed our benchmark for our reserves management. Unlike Treasury, we developed a benchmark in-house with input from what we saw other people doing and a number of other things. We thought it would be useful to have an independent expert review that benchmark, so we got Frank Russell, which is a very highly regarded US actuarial and investment consulting firm, to help us. They came in and they did a competent job, but there were plenty of people in the bank who knew more about the topic than they did. That was my assessment.

Senator MURRAY—Are you suggesting that the process of review and the use of external advice by the Office of Financial Management is therefore flawed and they should just rely on internal processes and internal expertise?

Mr Battellino—I think they have to make a judgment about what the qualifications of their staff are. I cannot comment on that. Certainly I feel that we have the expertise within the bank to do a lot of the work that we need to do ourselves rather than get consultants in. Whether Treasury feel the same, I am not sure.

Mr Allen—We believe that one of the core competencies we must retain internally is the expertise to provide an understanding of the benchmarking process, similar to the approach adopted by the Reserve Bank. We need to have the expertise and intellectual knowledge internally so that over time we can maintain that expertise. In addition to that, we also believe that seeking external advice to provide further input into the development of the benchmark—perhaps design certain aspects where that expertise is not available in-house—is an important aspect of the continuing development of a benchmark which is relevant, robust and can be attested from a financial market perspective as well as the requirement of government. It is an ongoing process and a dynamic process, but it is reliant on maintaining core competency internally as well as being able to source external expertise on an ongoing basis.

Senator MURRAY—But Mr Battellino's point is different. He maintains that their internal expertise is such that the external advice could not add that much to their view of the world. That means that either they have extraordinary competence which is not available externally or they chose the wrong advisers. My question to you is: are you wasting your time if you already have the internal expertise?

Mr Allen—I think one context of that comment is that our resource base is obviously significantly less than the Reserve Bank's, so on that basis we perhaps have a different business need than the bank. Our office is currently staffed in the low 20s. Under the formation of the office there are plans that we can employ further expertise from the private sector. We will be introducing skills across a fairly broad range of different skill sets, so I do not think that we will necessarily, over time, have the appropriate level of resources to develop an in-house competence that would be maintained over time. Obviously I do not know about the Reserve Bank's operation; perhaps there is a difference between their business and our business which would perhaps explain the differences in approach.

I am not saying that the Reserve Bank approach is not consistent with ours. I think that when you are employing external advisers it is very important that you have the expertise and in-house skills to ensure that the advice you do get from outside is of value. I think there are well documented cases where you do get independent advice and that independent advice is not adding to the intellectual and core competencies of the group. I have seen those examples certainly in my work experience. I am not sure whether we have a difference of opinion; it is just the way in which we intend to approach that business issue from the officers’ perspective.

CHAIRMAN—Mr McPhee, from your audit activities—perhaps I have to ask Mr Allen this—are you satisfied that there is a clear separation of duties between the trading function, the settlement function and the reporting function to make sure that the office avoids fraud? I particularly have in mind that we would not like to hear of a Nick Leeson in Australian financial matters.

Mr McPhee—Just broadly, during the audit, because Treasury did resource this function with quite a limited number of staff, the points that you have raised were an issue to be considered. I think going forward the AOFM is seeking to address some of these issues a bit more distinctly than Treasury may have. So it is clearly an important element of the control framework. Our assessment currently is that it is moving in the right direction.

CHAIRMAN—Quickly enough?

Mr Kaufmann—Yes, it is.

Mr COX—I have a few questions about corporate governance and some other minor related matters. Is the board of AOFM an advisory board or is it a board which makes decisions which the executive are then bound to administer?

Mr McCray—It is an advisory board. The model under which AOFM was established technically is a prescribed agency under the Financial Management and Accountability Act. The reporting line formally runs through the Secretary to the Treasury and then to the Treasurer. So the advisory board is there to advise the Secretary to the Treasury. He is of course mooted to be the chairman of the advisory board.

Mr COX—But he essentially has the last say on any issue?

Mr McCray—He does. Obviously, the Treasurer can intervene, too, but in practice, yes, the Secretary to the Treasury has the power.

Mr COX—There were a couple of practical matters relating to electronic recording of bids. I take it that the Reserve Bank electronically records bids in its dealing room.

Mr Battellino—Yes. All our dealing rooms are recorded.

Mr COX—You would have been doing that since time immemorial, wouldn’t you?

Mr Battellino—I cannot remember back that far, but certainly so far as I can remember.

CHAIRMAN—We have an honest public servant!

Mr COX—When is AOFM going to start recording bids?

Mr Allen—Currently the plan is that the existing Treasury telephone system is replaced, which would then enable digital recording, or recording of conversations. Unfortunately, that upgrade is not planned until the end of the calendar year. Prior to that, we have introduced a number of procedural controls with which we are seeking to address the issue that has been raised in the report. Obviously, the cost of moving to that in the short term—it is an issue of technical capabilities essentially.

Mr COX—The number of people doing the management function in Treasury, from my memory of six years ago, was 14 or 22—something of that order. Have you had a significant increase in staff as a result of setting up AOFM?

Mr Allen—We are currently resourced at 23. There are plans in the original formation of the office to include staff to a number of 40—was it Peter?

Mr McCray—40, yes.

Mr Allen—Since my appointment, part of the review process has been undertaken. We will be making the appropriate recommendations for appointment of external resources. At the moment, our initial focus is looking at the strategic issues. Once we have passed that stage, we will then specifically address the resourcing issues needed to actually undertake the management task.

Mr COX—The final thing that the report leads me to want to ask is what you have done to address some of the legal issues in the short term. On page 87, paragraph 5.18 says:

> Failure to complete a Master Agreement involves legal risks, particularly concerning the possible unenforceability of contracts. ...
>
> The only exception is where the Master Agreement has been agreed but is awaiting signature.

It would seem to me that if the thing had not been signed you would have an unenforceability problem. There seemed to be concerns elsewhere in this report about which laws are applicable to which swap agreements, and a suggestion that some major banks' ratings agencies insist that they use New York law. I was wondering whether you could tell us something about those two matters and whether you have a clear idea of what risks New York law leaves us exposed to.

Mr Allen—Certainly. We have taken a number of actions. We are required to renegotiate existing agreements. Where there have been deficiencies identified in terms of the signatories to agreements or authorisations of the like, we have certainly put in place management actions to make sure those outstanding lists are received from counterparties. Those recommendations that are in the report, particularly with respect to the legal issues, have been reviewed by management and have also been reviewed by the audit committee. There are a number of issues that remain outstanding, particularly in terms of renegotiating existing contracts. There is a very strong reluctance from counterparties to negotiate some of the existing clauses, particularly where they have a preference for using English law and New York law to swap agreements. But our policy is that, for any new agreements entered into, these issues have to be negotiated before those agreements can be signed.

Mr COX—But you would have a reasonable amount of bargaining power, given that you could simply say to any institution whose master agreement you were not satisfied with that you are not happy with it and you will not do any more swaps with them until you have one that you are satisfied with.

Mr Allen—Certainly. Where that is appropriate, where we are entering into new transactions, that is certainly one of our strategies, yes. Some of the issues that were raised in the report relate to counterparties that we may not necessarily be entering into new transactions with. That becomes a slightly more complex negotiating issue. As a management group, we have addressed those issues in detail and we would be happy to table our actions to date with respect to those issues, for your information.

Mr COX—That would be helpful.

CHAIRMAN—Could I first say that, in jousting with Mr Battellino, I did not mean to imply that any public servant whatsoever was anything other than 100 per cent honest. So we have cleared that up. If nobody minds, if we have follow-up questions—and we may well do, because this is a complex area and I do not pretend to understand the detail of these transactions in any sense—we will put them to you in writing and we would appreciate your early response so that our report is not unduly delayed. On behalf of the committee, I thank all of you for coming and for helping to enlighten the committee on these important issues.

[12.15 p.m.]

BORTHWICK, Mr David, Deputy Secretary, Department of Health and Aged Care

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

MACLACHLAN, Ms Rita, Acting Director, Conformity Assessment Branch, Therapeutic Goods Administration, Department of Health and Aged Care

MORRIS, Dr Clive, Head, Molecular Biology Section, Therapeutic Goods Administration Laboratories, Department of Health and Aged Care

MOSSOP, Mr Mike, Director, Plasma Products and Organ Donation Section, Blood and Organ Donation Task Force, Health Services Division, Department of Health and Aged Care

SLATER, Mr Terry, National Manager, Therapeutic Goods Administration, Department of Health and Aged Care

TRIBE, Mr Robert, Chief GMP Auditor, Conformity Assessment Branch, Therapeutic Goods Administration, Department of Health and Aged Care

WELLS, Mr Robert, Acting Chief Executive Officer, Office of National Health and Medical Research Council, Department of Health and Aged Care

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

CHAIRMAN—We now come to the second report to be examined by 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. 24 1999-2000: *Commonwealth Management and Regulation of Plasma Fractionation.*

I welcome representatives from the Australian National Audit Office and the Department of Health and Aged Care to today's hearing. We have convened this public hearing to examine the main issues raised in Auditor-General's report No. 24 on the Commonwealth management and regulation of plasma. Mr Borthwick, do you wish to make a brief opening statement before we proceed to questions?

Mr Borthwick—I would like to make a short statement. We set out our views fully in our submission. We hope we have made our points clear. We have addressed in our submission those areas in which we agree with the emphasis of the ANAO and those areas in which we disagree with their emphasis. We clearly agree with their three recommendations and that is set out in our submission. We could have had a better process in reviewing the blood fractionation agreement—there is no doubt about that—and the report does contain some useful lessons which we can draw upon for the forthcoming review with CSL which is scheduled to commence in June 2002.

But, notwithstanding those shortcomings in process, we believe that our contract with CSL achieved the outcomes which the Commonwealth sought to achieve, and these are outlined in our submission. I also want to place on the record that there are a couple of areas where we believe that the ANAO's conclusions are based on assessments of legal and accounting issues which we and our independent experts have differing perspectives on. They are addressed fully in our submission. We have attached both legal and accounting advice so that you can draw your own conclusions about that.

On the issues addressed in the Audit report concerning the TGA's product safety regulation, it is our view that with respect to two of the key issues—namely, the failure of the New South Wales Australian Red Cross Blood Service screening kit for hep C and CSL's failure to obtain prior approval from the TGA before importing and fractionating plasma—the regulatory system was shown to work well. The problems that arose were picked up and safety was not compromised. Those areas of program administration that needed to be improved were acted on decisively and they were improved, but those particular areas in no way compromised the safety of our blood supply. We hope we have addressed those issues adequately in our submission.

That is all I want to say, other than that there are, no doubt, as I mentioned before, some lessons for us in this process. I think we have adequately taken those on board in actions to date, and we are pleased to expand on those in response to your questions.

CHAIRMAN—Mr McPhee, do you have an opening statement or any response to a couple of things that Mr Borthwick has just said?

Mr McPhee—Thank you. I think David summarised it fairly well. Fundamentally there is some scope for improvement in this area, and the department has accepted the recommendations made by the ANAO. There were some accounting and legal issues where there was some tension. While we can explore some of the technical issues, I think there are still some underlying points or lessons that the department might bear in mind going forward. We would be happy to talk further about those.

CHAIRMAN—There is no question from our viewpoint that the Audit report found marked deficiencies in the department's payment control system for some $400 million in Commonwealth payments. That is pretty significant. We are at the moment conducting a major inquiry into contract management by Commonwealth departments. I had not realised that the Department of Health and Aged Care was such a big player in contracts, but perhaps we will now do something about resolving that deficiency. Can you convince this committee that you have now put control systems in place to ensure that you are not overpaying CSL, that you are not paying for variations or procedures that you should not be paying for? As I read the Audit report, it seemed to me that the relationship was very sloppy. If CSL wanted it, they got it.

Mr Borthwick—I think the key point is that we have now put in systems which will be able to reconcile all the invoices, and we have enlisted the help of the Australian National University to do that. I hope that is set out clearly in our submission in terms of the actions. My colleagues might elaborate on exactly what was done in that regard. With the benefit of hindsight, there is no doubt that we should have moved quicker than we did, but I will make a couple of general points. First, our own advice to us suggested that the risk factor was relatively low in terms of there being anomalies. Secondly, we kept on holding off developing a reconciliation service because of the expectation that the Red Cross was going to develop a system which would enable that to be done pretty efficiently. In the event, that has taken the Red Cross—I am not try to blame them at all; I am just stating it as a fact—a lot longer to do. I think our attention has been sharpened up by the ANAO’s finding that we had to do something very quickly, especially for those payments which were not to the Red Cross, which were about 20 per cent or a bit less. Perhaps my colleagues can set out the sorts of territory we have covered in our submission as to what we have done to make sure that there are not any problems in the future.

Mr Mossop—The task for us is to reconcile about 50,000 invoice records a year for products received by upwards of 3,000 recipients. We have decided that we will reconcile fully all of the goods received by the Red Cross and we will sample the receipt of goods and products by the other group, the non-Red Cross group. We have developed a sampling system. We have tested the methodology that has been assessed for us by the ANU and we hope to go online on 1 July with the full reconciliation system.

CHAIRMAN—The thing that I find a bit difficult to understand, I am afraid, Mr Borthwick, is that in 1995 there was an Audit report on the sale of CSL which said that the Department of Health and Aged Care ‘did not have in place an internal control system which could reconcile invoice provided by CSL with receipt of products’. That was an Audit report from 1995. Why on earth did the department take until now to take this issue seriously? I agree we were not a committee of audit then and we are now, but that seems to be an appalling lack of bureaucracy’s attention to what is a clear breach of financial accountability? How on earth do you justify waiting so long to decide to do anything?

Mr Borthwick—The key point is—and again it is with the benefit of hindsight—that we were looking for the Red Cross to put in place a system which would enable us to do it. The second observation I would make is that, subject to what my colleagues have to say, I think there are linkages between the Red Cross and CSL, such that if the Red Cross was not getting the product at CSL there would have been an alert put up very early in the piece. So the advice that we commissioned—albeit too late in the process—said the risks were minimal as far as the Red Cross was concerned. But, as I have said, we think the Audit Office has a point in this regard and we should have moved more decisively.

There is no evidence that the Red Cross-CSL interactions caused problems. We are not aware of any money that has gone astray. We believe that we would have been alerted to that throughout this process. So we think that the assessor was right: the risks, as determined by the assessor when we had this looked at, were small. Nevertheless, it was a matter that should have been attended to in a more timely fashion. It has been attended to now in a comprehensive fashion, and I do not think the audit office are disputing that. They are disputing the past, and I am agreeing with that, but I think the mechanisms that we have put in place can guarantee your committee looking into the future.

Senator MURRAY—Which officer or officers would make that decision?

Mr Borthwick—To do what, Senator?

Senator MURRAY—Which officers took that decision not to pay attention to the 1995-96 recommendations?

Mr Borthwick—I do not think I can point to particular officers. I think it was just ongoing interaction between us, CSL and the Red Cross which came to that view.

CHAIRMAN—Mr McPhee, are you satisfied that the risks were small?

Mr McPhee—I think the issue is perhaps more fundamental. It is fairly common practice to ensure the receipt of the goods before you actually shell out the money. I think it is a fundamental control matter we are talking about, and the control is designed to protect the Commonwealth's funds.

CHAIRMAN—You would get no argument with that.

Mr McPhee—Secondly, it is comforting to hear David Borthwick say that it is being managed now, but back in the earlier report the department actually told us that the issue was being addressed by the department at that point in time. So one of the issues that the report raises is really what assurance the management in the department gets that recommendations by this office and by internal audit are actually addressed and implemented. So there is a wider issue in there, as well.

Senator MURRAY—The reason I interrupted is that there is a very clear need here to establish who is responsible for ensuring that the Audit Office's recommendations and other important recommendations are complied with. In the answers we have had so far to questions from the chair, that has not been established. If there were no particular officer or officers with ultimate responsibility, we as an audit committee would seek to establish that somebody did have that responsibility in future so that, if this occurred again, we could say the secretary to the department or the head of the particular agency had ultimate responsibility. That is what lay behind my question. That is the issue.

Mr Borthwick—What lay behind my answer was not necessarily to want to point the blame at any individuals or any particular area. I have no doubt that if we agree with an audit recommendation back in 1995 or whatever the expectation is that it will be done, unless there are circumstances which override or change the premise. That was not the case in this case. As I said, there were mitigating circumstances in trying to wait for the Red Cross to put in a system, but that reason was not sufficient. As for the more general question of how you can be sure that the department acts on recommendations in the future, this is a matter that our internal audit committee is actively pursuing. The executive gets regular reports on the status of recommendations. So there are internal mechanisms by which senior managers get feedback so that they know whether or not the action area is following up recommendations.

Senator MURRAY—So the three recommendations that are in the auditor’s report will be reported to the chief executive of your department in future. Who will that chief executive report to in terms of the fulfilment of those recommendations?

Mr Borthwick—I am not the chair of the audit committee—the other deputy secretary is—so I am not across the details of the process. The department’s current process for follow-up of ANAO recommendations involves the audit committee, as I said. There are also quarterly reports sought from FASs, the prime line managers, as to progress of those.

Senator MURRAY—They report to the committee?

Mr Borthwick—To the audit committee, yes. The ANAO is also represented on our internal audit committee, so it is not just an internal process. The ANAO can ask questions. We are also intending that there be periodic reports direct to the minister.

Senator MURRAY—So the audit committee reports to the executive committee, both the audit committee and the executive committee liaise with the ANAO and the executive committee, through the chief executive officer, reports to the minister?

Mr Borthwick—It would either be the secretary or the head of the internal audit committee who would send periodic reports to the minister.

Senator MURRAY—Right at the heart of my understanding of the report, your submission and so on is a lack of accountability for the recommendation. From your answers, from your lead-up earlier and from the auditor’s report it appears there was no specific person or officers with a responsibility for the fulfilment of those recommendations from 1995 onwards. Is that a correct understanding of the situation?

Mr Borthwick—I think the matter was not paid the urgency that it should have been paid.

Senator MURRAY—But no specific body or person had responsibility for monitoring that. There was no process or responsibility, was there?

Mr Borthwick—I might hesitate there because it is in the period before I was involved in the department. I have now just received advice. I would have to say that your portrayal is a fair one.

Senator MURRAY—You are assuring the committee that it will not occur again. Is that correct?

Mr Borthwick—That is exactly right. These processes, which I described before in terms of making sure that things are followed up, were put in place last year.

Senator MURRAY—You have made it clear to us that you believe there is no evidence that moneys were lost. Does that also have the countervailing point, the negative point, that there is no evidence that money was not lost, or do you think that is just taking it too far?

Mr Borthwick—I think the point is that there could always be some mistakes in particular invoice reconciliation. But, in the overall scheme of events, we do not think any moneys have been lost.

Senator MURRAY—If you were wrong by one per cent, $4 million would be involved.

Mr Borthwick—I think I can go a bit further. When we were developing the system with ANU—subject to what my colleagues have to say—I think we back-cast a little bit to see whether or not the system would work, whether it was robust. There were some gaps in the invoice reconciliation system, but I think it showed that it was pretty robust. That is my recollection.

Mr Mossop—That is in fact true, yes. But, of course, we cannot guarantee now that of those 50,000 invoices there was not one that was wrong. But, based on the records which we receive from CSL on a monthly basis and information from the Red Cross, who also get that information on a monthly basis and do their own internal reconciliation, we believe there is a very low risk of there being any significant overpayments or wrong payments. But, of course, there could be the odd record here and there which is wrong.

CHAIRMAN—But you are saying that, over the life of this agreement with CSL, you do not think there has been any serious overpayment. I will refer you back to the Audit report where you advised ANAO in the initial review in 1996 that, if you had accepted all of CSL's claims for increased costs, it would have resulted in an increase in annual Commonwealth outlays of $5.8 million and, if you had rejected all of CSL's claims, a decrease in outlays of $1.4 million would have eventuated. So the outcome of that negotiation process with CSL was an increase in annual outlays of $3.5 million. My question to you is: regarding that initial negotiation, what on earth led the department to make a conclusion that $3.5 million was a reasonable outcome?

Mr Borthwick—That is a different issue altogether. If we want to go on to that issue, I am happy to do it, but it has no relationship to the previous issue.

CHAIRMAN—I beg your pardon?

Mr Borthwick—The issue you have touched on now is the price that we said—

CHAIRMAN—I thought you said to the committee that, in this relationship with CSL and Red Cross, there was no evidence that the Commonwealth had spent any money that they should not have.

Mr Borthwick—That is exactly right. But the issue that we have been talking about up until now is that of the reconciliation of invoices between the Red Cross and other parties and CSL. As I understand it, the issue you are now broaching is the reasonableness of the overall contract price that we have set with CSL. That is a separate issue, unless you are drawing a link that you might be able to explain to me so that we can help you with our answers.

Mr McPhee—I would agree with Mr Borthwick that the issues are quite distinct. One issue concerns the arrangements for making the payments under the existing contract, and the other one is to do with the forward-looking perspective in terms of the new arrangements.

CHAIRMAN—Fair enough. I am with you. Let us go back and address that increase in cost then.

Mr Borthwick—With respect to that cost, I have mentioned that in our submission we tried to set out that the Commonwealth had a number of objectives. One was to make sure that there was a secure supply of blood and plasma products, and that was an important thing. The second objective was to make sure that we get a competitive price for that overall contract and that we have a regulatory framework in place that can guarantee safety and quality. In other words, at some point, if you press too hard, CSL might cut corners. If I could draw a parallel, it would be a bit like an airline safety issue. If you press too hard, you could compromise quality. So we were very mindful of that. We also had in the back of our minds some sorts of international benchmarks that should apply vis-a-vis product pricing. But we were conscious that CSL was in a monopoly position. We were conscious also that they had installed new plant and that there were not ready benchmarks in that regard.

You ask how I can be sure that the price is the right one. I do not think in any negotiated outcome you can guarantee that you have got the best deal, but we think it was around that sort of price. We can refer you to, for example, the sorts of international comparison prices which the Audit Office have included in their report of selected countries where we think statistics are comparable. They show that the Australian price is lower than that of most international countries. That is in the report on page 47. That chart suggests that the Australian price is below that of other countries where there are comparable sorts of market conditions.

So I guess my point is that you can never say in a negotiated outcome that you got the best end of the stick. But in trading off those broad objectives—getting a fair price and a secure supply, maintaining the safety of the system—we think we did quite well. In terms of the details of both our interpretation of the contract and our approach to it—whilst the Audit Office might have a different assessment—we are of the view that the opinions we got subsequently in the accounting approach suggest that our judgments were right at the time. So I would suggest to you that that is the general sort of terrain.

Mr COX—Just to change tack, I would like to ask you some questions about the risks associated with imported blood products and the amount of exposure that Australians have to those risks. It is my understanding that Australia probably does not produce enough blood to provide all of the sorts of blood products that are required. The case I am thinking of is haemophiliacs. There have probably been, over the years, rationing processes in place in terms of rules for people to get access to those products as a way of warding off bleeds. In the past, people have got hepatitis C from using those products. I have somebody in my electorate whose son has hepatitis C. He unfortunately has another son who has haemophilia but who does not have hepatitis C and is now receiving another product which I think is synthetic. That synthetic product, as I understand it, was designed to avoid possible problems of contamination of blood products. It is not available to his hepatitis-positive son, I suspect because of either the cost or the quantity that is physically available. The father is therefore concerned about the risk of the son who has hepatitis C contracting further diseases as a result of continuing to be exposed to blood products that are foreign sourced or even possibly Australian sourced but with new viruses that might become evident in future years. Do you have any comment on that?

Mr Borthwick—I will rely on expertise from my colleagues, but as a general comment it has been a long tradition in Australia that we do try to be self-sufficient in our blood supply because we think there is less risk than relying on imported products. But there are products for which we cannot adequately cater; there are relatively few for specialised needs where we do import product. Can I rely on my TGA colleagues to pick up the specifics of the question.

Mr Slater—I will go first and then turn to our blood scientists. I think the key thing here is that Australia, relative to the rest of the world, has perhaps one of the safest blood supplies in the world. That does not mean that all bases are covered and there is no risk of contamination. We only have to look at new variant CJD, for example, from mad cow disease in the UK, as being a risk that has emerged in the last decade that no-one was aware of. We are still establishing whether that is transmissible through the blood supply, for example. If we look at the outcomes in Australia, in the last three to five years there has only been one known case of transmission of HIV-AIDS through fresh blood. For our fractionated products, the TGA has insisted that the CSL adopt world’s best practice in the production of its blood products through plasma fractionation. We now have two antiviral steps which the regulations require CSL to follow in the production of its blood products which, for HIV for example, reduces the risk to 10 to the minus 14. It is a very small risk. For hepatitis C there is a similar reduction.

We also have required CSL to introduce the latest nucleic acid amplification technique, which is a new polymerise technique which is being used only in Germany, the US and now in Canada. It is to be required from 1 July this year and will reduce the window period for fresh blood in Australia by about 50 per cent. For CSL, if you look at that 10 to the minus 14 figure, again that will reduce the possibility of contamination dramatically even further by a considerable margin. I guess my point is that through the regulatory system that we have, while we cannot rule out unknown risks, with the risks that we are aware of we have taken every step possible to ensure that recipients have access to the best and safest practices in the world for their blood products.

Mr COX—Is Australia importing blood products that are not as carefully prepared as CSL’s?

Mr Slater—To my knowledge, there is only one imported blood product that is registered for use on the Australian market, and that product is also required to achieve a double viral inactivation stage.

Mr COX—What about the availability of synthetic products?

Mr Slater—The issue with synthetic products is that they use biotechnology. I would need to turn to our molecular biologist, Dr Clive Morris.

Dr Morris—Firstly, all products are subjected to the same level of pre-market evaluation, so I do not think you can say that there is a discrepancy in the safety between blood products, be they derived from blood or synthetic, on the Australian market. But, in terms of availability, a lot of that is due to decisions of use and funding. I do not want to be seen to be passing the ball, but I think there are some larger Commonwealth-state committees involved in making decisions on availability. Maybe Mike or someone else could comment on that.

Mr Mossop—Currently, we import synthetic factor VIII, and about 25 per cent of total factor VIII usage now—

Mr COX—What is that used for, Mike?

Mr Mossop—It is used to treat haemophilia A, which is the normal factor VIII deficiency. About 25 per cent of total usage is derived from the synthetic product. Guidelines have been established for access to the recombinant product. Basically, if you are a new user of factor VIII, you get first access to the recombinant product. If you are viral free—in other words, you have not got HIV or hepatitis C—you get second access to it. You get access to it based on age, so if you are under 18 you get access to it. Those access guidelines were worked out by clinicians in the field, and they have been agreed to by the national haemophilia body. Were we to go to total use of recombinant factor VIII, which is the synthetic product, it would cost us about $60 million. So, in a sense, cost is obviously a factor here when you weigh it against the perceived safety gain. To be honest, the safety gain against current known risks is very slight. There is virtually no gain.

Mr COX—With the synthetic product?

Mr Mossop—In terms of current known viruses and risks.

Mr COX—Giving total surety against future blood borne risks?

Mr Mossop—You never can.

Mr COX—But from that source?

Mr Mossop—From which source—the plasma source?

Mr COX—Yes. For the recombinant factor VIII.

Mr Mossop—From the plasma derived factor VIII, no, you cannot. But the viral inactivation steps used by CSL now are very effective against HIV and hepatitis.

Mr COX—But what about the synthetic?

Dr Morris—Because its starting material is free from the risk of contamination, it will be perceived to be safe—it will always be perceived to be safer—despite the fact that the manufacturing process for plasma derived product has been changed to remove more viruses than you could possibly load on the system.

Mr COX—But will the synthetic product be safer?

Dr Morris—I think, in the magnitude of things, it is a perception of safety rather than a real safety.

Mr COX—But, in absolute terms, is the synthetic product absolutely safe—price tag, $60 million—against presently unknown blood borne diseases that might later turn up in the plasma?

Dr Morris—I am sure that if you asked a clinician they would say, yes, it is safer. But they would be making a cost-benefit analysis about what they were using.

Mr Borthwick—I think we pointed out in our submission some of the risk factors in contracting some of these things. For hepatitis A it was one in 10 million, hepatitis B less than one in a billion and hepatitis C less than one in a million. So it can happen, but it is whether or not you want to spend the marginal health dollar, which is $60 million, to lower those odds even further as distinct from spending it on other areas of the health budget. Unfortunately, that is a decision that governments have to take.

Ms GILLARD—I do not think anyone is diminishing the difficulties of that decision, but what we are trying to get clear is that there was a period when the blood supply was not secure against HIV and hepatitis. You have now got a protocol where you test for that and it has brought the risk factors down to the figures that you have been quoting, but there is still some risk, negligible though it might be, from those known viral factors. Then, of course, there has got to be a world out there of potentially unknown blood borne diseases that science today does not let us diagnose or know about, in the same way that there was a period when science did not let us know about the HIV transmission problem through the blood supply. I think what Mr Cox is asking is: if you were willing to pay for the synthetic—and of course there is a whole policy question about that—is the synthetic 100 per cent safe against known and unknown contaminant problems?

Dr Morris—Nothing is safe against unknown problems.

Ms GILLARD—But how could it be contaminated if it is synthetic?

Mr Slater—Can I put a perspective on it. The biggest cause of illness and death from transfusion of blood is not through viral transmission; it is by microbial contamination or, unfortunately, through mismatching, where the wrong blood type is transfused into a patient. I do not think those factors, which are far more significant than viral transmission, would be removed by the use of synthetic products.

Dr Morris—Most of those problems are blood transfusion related.

Mr COX—This father’s problem is that when his first son was diagnosed with haemophilia he was not able to get factor VIII to use on a regular basis to reduce the number of bleeds. That son has now got two problems: one is that he has had so many bleeds that his joints have been badly affected; and the second is that he has got hepatitis C. What he does not want to see happen is, if there is a solution to that problem now for his younger son, who also has haemophilia, that his first son winds up with another blood borne disease when there was a solution to that problem in the form of a synthetic factor that is not currently available to him.

Mr Slater—It would probably be worth getting Dr Morris to talk about what might be coming down the track in terms of biotechnological developments. I would expect that as these products become cheaper then the paradigm and the cost-benefit decision will change. There is much speculation throughout the world as to whether in due course fresh blood will be the major means for making available blood for transfusion. It may well be that with gene technology developments recombinant techniques prove to be the most cost-effective way of dealing with that. I would ask Dr Morris to talk a bit more about that.

Dr Morris—What we are seeing is a worldwide trend. If you are looking back in five-year chunks, the safety and the quality of products are improving all the time. Maybe in 10 or 15 years time all the products which are currently manufactured from blood plasma will be made using synthetic means. There might be herds of transgenic goats in America which will supply all the factor VIII the world needs. That is an ongoing trend.

Market forces will ensure that the costs of these products come down. The cost of recombinant factor VIII I think is probably half now, today, what it was three or four years ago because there is competition in the marketplace and market forces are driving the price down. When new technologies come online the price will go down even further and it will replace the products which are made from plasma, simply through price.

Mr COX—When was the last time the guidelines for availability were reviewed?

Dr Morris—I don’t know.

Mr Mossop—They were reviewed in October-November last year. Basically they have not changed. There is still this sense that if you are virally compromised, as they say, then in effect you go down the list.

Mr COX—If he is less than 18 years of age but has hepatitis C, is he eligible now?

Mr Mossop—The actual cut-off depends on the volume. As the volume goes up then each of those groups gets caught up, picked up in any increasing volume. For those under the age of 18 with hepatitis C, where they are now on the list I am not sure, but they are not at the very end of it, that is for sure.

Mr COX—Would you be able to send me something in detail about where they would be?

Mr Mossop—Yes.

Mr Borthwick—You want us to send you the guidelines so you can pass—

Mr COX—Yes.

CHAIRMAN—I have one last question. Very briefly, you obviously put a recommendation to:

(b) commence early planning for the expiry of the initial term of the PFA contract to ensure that the Commonwealth can advise CSL Limited of its preferred position by May 2002 ...

Is that in train?

Mr Borthwick—Yes, it is. We have put increased resources into this area in the department (1) to attend to matters which the Audit Office has addressed so far but (2) with respect to that forthcoming review. We also initiated—or the minister initiated—the review of blood which is being undertaken by Sir Ninian Stephen and other reviewers. It will be fundamentally looking at the sorts of safety issues which we have just touched on, and also the issues concerning the Commonwealth and state governments interactions with both CSL and the Red Cross. We have done that because there is this interaction between safety and dollars, I guess, ultimately, to try and make sure that the community has confidence in the integrity of our administration but, more importantly, of the blood system, and that is why the minister chose such a distinguished group as Sir Ninian Stephen, Dame Margaret Guilfoyle, Professor Judith Whitworth, who is the head of the John Curtin Medical School, and Professor Bob Beale from Adelaide. I guess what I am saying to you is that we are bending over backwards to make sure that there is confidence in the system.

CHAIRMAN—Do you have any final comments, Mr McPhee?

Mr McPhee—Just to say this is obviously an area where departmental governance is very important, both from the point of view of protecting the Commonwealth’s interests from the financial perspective and, as David said, from the safety perspective as well. So it is a very critical area to get right.

CHAIRMAN—Could I just say on behalf of the JCPAA to the department that had we been an audit committee of the parliament following the department’s lack of attention to audit recommendations in 1996 we would have had a hearing much earlier than now and it would have been in, I might say, much more aggressive terms.

Mr Borthwick—I think we could have done with a hearing earlier than this, too, if I might say.

CHAIRMAN—We will agree on that. If we have further questions, do you mind if we put them in writing?

Mr Borthwick—Please do so, yes.

CHAIRMAN—Thank you very much

Proceedings suspended from 1.00 p.m. to 2.18 p.m.

KEARNS, Dr Graham Richard, Head, Industry and Procurement Infrastructure, Department of Defence

NEUMANN, Mr Claude, Inspector-General, Department of Defence

ROCHE, Mr Michael, Under Secretary, Defence Acquisition, Department of Defence

WILLIAMS, Dr Ian Sidney, First Assistant Secretary, Resources and Financial Programs, Department of Defence

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

MINCHIN, Mr Anthony, Executive Director, Australian National Audit Office

McNALLY, Mr Ray, Senior Director, Australian National Audit Office

CHAIRMAN—Welcome. We now come to the final Audit report to be examined in today's public hearing. I remind witnesses that the hearings today are legal proceedings of the parliament and warrant the same respect as proceedings in 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. 13, 1999-2000: *Management of Major Equipment Acquisition Projects.* We have convened this public hearing to examine the main issues raised in that report. Mr Roche, do you have a brief statement you would like to make?

Mr Roche—No, thank you, Mr Chairman.

CHAIRMAN—Mr McPhee.

Mr McPhee—Thank you, I will make a brief statement. This audit largely arose from the committee's concerns expressed during its review of the JORN and new submarines projects in reviewing the audits on these particular acquisitions. We recognise that Defence is extremely large and complex and the acquisitions element of the department is business critical. In summary, the audit concluded that the overall management of Defence's acquisition projects has experienced some systematic problems, and both the ANAO and the department saw scope for improving the higher level management of major projects. To reinforce, or in some cases to suggest extension of, changes under way in Defence, the report made recommendations directed at encouraging the department to consider in the longer term the benefits of allocating budgets for Defence's capability outputs to the relevant output managers, who in turn would fund the functional groups through purchase of provider arrangements; reviewing the budget carryover arrangements to support a more commercial approach; regular high-level reporting by project managers to give an objective overview of progress on major projects for review by senior managers, with exception reports to senior executives; applying proposed standard project management methods to all groups involved with the acquisitions; and, finally, producing a personnel work force plan that better integrates work force initiatives to increase the availability of experienced project managers. I will leave it at that. That is a broad overview of the audit findings.

CHAIRMAN—Thank you very much. Mr Roche and colleagues, the Audit Office in this report essentially said that overall management of acquisition products has experienced systemic problems arising from a traditional top-down management of Defence's various functional groups without fully effective lateral processes by which capability outcomes can be better managed. This is a long question, but one of the things we would really like to know is where you think Defence is headed today with reconsideration of project management. We could take as an example the Collins class submarine—I am not here to give you a rough time. This is a practical question which should get a practical outcome in terms of management. I would like to know what Defence's thinking is today, not on how to fix Collins but how you would approach the issue were you starting today.

The question is this: the combat control system was specified and became part of the contract at a time when fixed architecture was all the go in terms of computer systems and so the control panel itself had lots of functional buttons. The systems engineering and the programming were all set to do a multitude of tasks with a great range of inputs into the system. Somewhere along the line somebody realised that this was no longer appropriate, that the world had moved on and there were such things as personal computers; we had Windows 95 and Windows whatever and it was a different way of doing things. It was not the head of Navy, I suspect, who said, 'Well, ASC must meet the contract specification, even though that today is probably silly.' Somewhere along the line somebody should have blown the whistle. They knew something was going wrong and they knew it was not going to make it, it was not going to work. It was not a Navy submarine, so the Chief of Navy did not make the decision. What I am asking is what sort of control or management structure you think is emerging that would be able to in the future address those sorts of problems. That is a long question, but I think you get the sense of what I am asking.

Mr Roche—Forgive me perhaps for a long answer, too. This Audit report and my appointment to the Defence Acquisition Organisation I think came together at pretty much the same time. Not only did Audit see a need for change in the way we did things but also the minister did.

CHAIRMAN—Us too.

Mr Roche—Indeed. I think the reasons for that were obvious. What I did very early on was to take account of these reports, and there were earlier Audit reports as well. I looked at the earlier recommendations from this committee. I had discussions with the minister. I have had extensive discussions with industry and with clients in Defence, with legal people and with other government agencies, and we have put together a program of acquisition reform which is now in front of the minister. That program of acquisition reform goes to just about everything that we do in the way of acquiring capital equipment from the moment we start to specify capability right through the acquisition process—consideration of options before we get there, right through the acquisition process, management of the acquisition process, project management into the through-life support phase. It is still work in progress. A fair bit of what we are doing is in place but there is quite a bit more to come. Indeed, I think the minister foreshadowed earlier this year the bringing together of Support Command Australia and the Defence Acquisition Organisation, and there is a consultancy on just that subject right now, again in front of the minister.

I think that the problems of Collins go right back to the specification of capability. One of the early recommendations we are making—and most of these are very obvious and I think they have been identified by a number of people who have some connection with the business—is that we need to become more functional in our specifications and to get away from highly detailed technical specifications that get down to the exact model of the computer and so on that we want in a combat system and start to specify more what it is we want in outcomes.

We also are looking a whole lot harder at Australian specific solutions so that we try and get ourselves into problems less frequently by specifying something that nobody else has done anywhere else in the world, and to try and acquire where possible weapons systems and equipment that are in use or at least have somebody else sharing the development pain. Having said all that, I think one of the important things to bear in mind is that defence acquisitions will always involve risk. My colleague Hugh White made the comment to me very early on in my time in Defence that you can take risk out of acquisition but you are just going to put it on the battlefield, and defence acquisition is about buying equipment that is very much state of the art and at the leading edge—hopefully not the bleeding edge—of technology. These days you are trying to get the technology edge on your opponent, and you do not do that by buying only off the shelf, only proven equipment.

CHAIRMAN—You still have not totally answered the question. I am asking this: in an organisational sense, whose responsibility is it for that submarine? Is it the head of Navy?

Mr Roche—Until it is delivered, it is my responsibility.

CHAIRMAN—Totally your responsibility?

Mr Roche—It is my responsibility to deliver the submarine according to the specifications. One of the things we are doing is making that level of responsibility a lot clearer so that the number of people who can input into the process is reduced. I am aware that the Audit Office recommended that the output manager be actually able to involve himself or herself in the project team. When the project seems to be going wrong, there is a fundamental question here of who has to take responsibility for the project team. If the output manager has the capability to move in and direct that team, then I cannot be expected to take the responsibility, but if it is left to me I will take the responsibility.

CHAIRMAN—So what you are proposing is that you own the submarines until they are ready to be delivered?

Mr Roche—That is right. It is one of my staff who actually signs the delivery documents for the submarines. It can only be by me taking responsibility for it that that is carried out. That is not to exclude the very proper role of the output manager. It is not as though we are taking something in to the Defence Acquisition Organisation and putting up the shutters. We have been accused of doing that in the past—putting up the shutters and saying, ‘Go away. We will buy it and you will get it when we are good and ready.’ We are changing our structures. We are moving to flatter structures. We have removed a number of committees out of the system because the committees tend to diffuse the responsibility. We are now strengthening the role of the project board. Project boards are a requirement of our project management method, the principal management method, and we are now making those the final stop in the process so that the project board recommends directly to the delegate on all key decisions. There are no intervening committees. That means that the output manager has a role, he has a place on that board, and he has a voice in the way that the project is managed, a very important voice, not one that is remote by several levels of committee.

CHAIRMAN—Who makes a decision about priority? Go back to the combat control system. To have made a change at any point in time was going to cost money once the contract was signed. Under the new system, at some point during the production of the vessels, a recommendation comes up the line from the systems engineers to the project managers and to you that says, ‘We’re not going to get what it is that we want. We think the Navy is not going to be happy with it and it may take far too long to get it.’ Who is going to make the cost overrun versus the meet-the-original-specification decision?

Mr Roche—At the end of the day I will make that decision if it is within my power, but many of these have to go to government. If a real cost increase is involved, then there is a formal process which involves a recommendation to the minister and in significant cases government gets involved. If we vary the scope of the project—and that means making any significant change to the capability—again there is a series of formal requirements that involve ministerial and sometimes government decision making.

Dr Williams—The threshold has just been raised. It used to be $20 million for a major project to be referred back to cabinet. I think that has now been raised—I think it is closer to $50 million now—for cabinet. There are numerous levels below that.

CHAIRMAN—When you were describing the process before you said—on new acquisition projects—something about trying to go for a capability that already exists in the world rather than so-called blue sky and using as much Australian capability as possible. I recall that on Collins the ship management system was also brand new and world class and it turned out to be spot on the money—in fact the rest of the world is trying to emulate it.

Mr Roche—And that does happen.

CHAIRMAN—Are you saying we will not do that anymore?

Mr Roche—No. We will innovate where we think that the risks are acceptable. We will make a risk judgment. Perhaps one of the problem areas with some of our projects is that we have tended to risk manage the entire project rather than risk manage the individual components of it. I think that was one of the criticisms of Collins, that in fact we subjected the whole project to pretty much the same regime and the same fixed price regime. I think it would have made a lot more sense to have treated the combat system under a different risk regime, and certainly the McIntosh-Prescott report recommended that it be treated on a different pricing basis.

CHAIRMAN—You have said that or something like it to this committee on an earlier occasion.

Mr Roche—I think it is still not an unreasonable proposition that you break the project up into its individual components. But perhaps I can give you some examples of the sorts of things I am talking about. A lot of the integration difficulties we face are not because we are inventing a new weapons system or a new sensor system out of the blue but rather because we are trying to take the best of a number of systems around the world. We like this avionics system, we like that airframe, we want that particular weapons system and we want something that has a range of 10 kilometres, not eight. Then that leaves you not so much with the difficulty of a system that is brand new—and not too many of these systems are brand new—but trying to integrate systems from a number of different places. That can increase the level of challenge significantly.

Dr Williams—Perhaps I could just clarify one thing. Just on the price triggers for various levels of approval, $20 million is still—I am fairly confident—the upper level. Beyond that, cabinet approval is required. With $8 million to $20 million the approval of our minister and the Minister for Finance and Administration is required. With $5 million to $8 million it is our minister, and below $5 million is the departmental approval threshold. I mentioned an increase: I am fairly sure that is still under review. But, given that the figures have been in place for some time, we are now looking to increase. But I think the $20 million is still the limit.

Mr Roche—I think it would be fair to say that we think some of those numbers and some of those processes need looking at as part of the overall process of acquisition reform.

Senator GIBSON—Mr Roche, could I take you back to recommendation No. 1 of the ANAO report which basically refers to reconsidering the management structure and recommends that the output managers be responsible through purchaser provider agreement. Unless the output manager—take the instance of the Chief of Navy, for instance—is responsible for a new project—say that we are ordering new ships of some sort—how will they do the trade-offs between capital expenditure and operating expenditure or between capital expenditure and quality of output? I raise that because it just seems to me that, in the commercial world, general practice is that a board will make a decision to buy a particular plant, or whatever it is, but then the project is delegated to a project manager who, because of certain expertise, often times comes in from outside. That project manager is told, ‘Here are the objectives, this is what you have to do, this is the amount of money and away you go.’ You did say earlier that you have made recommendations to the minister on the structure, and I am not asking improperly what your recommendations are, but would you care to comment further?

Mr Roche—Yes, I would make a couple of comments. Firstly, I would not make a decision on anything that involved a significant change of capability for something out of Navy without talking with the Chief of Navy. I talk with the Chief of Navy—in fact, I talk with all of the chiefs—a lot, and I would certainly want to know that they were comfortable with the decisions I was making. Secondly, the Chief of Navy has a representative on the project board. I have made it very clear to the chiefs that I expect them to have the First XI on the project boards, not the Second XI. The problem with some of our committee systems before was that they would save the First XI for the committee and what we want is the right decision making at source.

The third comment I would make is that one of the consistent problems I have found with projects that are in trouble is that capability was not tightly enough defined at the time we went into the proposal. It is this whole process of changing capability after you get into the proposal that really causes you some trouble. I would offer you the LPAs as a classic example.

Mr COX—What are LPAs?

Mr Roche—The landing ships, the rusty ships. So more than anything I am trying to get the output managers to nail down capability beforehand. Also, we are putting more effort up-front in trying to identify budgetary, schedule and other risks and technological risk for the given capability so that we do not have to come back and say, ‘Well, look, I’m sorry, we can’t actually do that capability for the money.’ To me that is failure, when we take a job on and we have to go back and say, ‘Well, I’m sorry, we can’t deliver the capability for the budget you’ve given us.’

Mr COX—Is it partly a failure of the planning process that capability elements are chosen and the service decides, ‘Oh, we want a new surface combatant,’ and they pick the size of boat that they want but they do not confess to all of the capability they want on it and then they start adding from the day they get approval to build the platform?

Mr Roche—I would not want to say that that has necessarily been the case in the past. But one of the recommendations that we are making to the minister about acquisition reform is that we change the way in which we develop capability up-front and we link it more closely to the strategic analysis and to the gaps that are identified and that the process of defining capability be a more formalised process than it is at the moment. At the moment the process of defining capability can be within a service and not necessarily drawn into headquarters as much as it should be.

What we want to do is involve acquisition staff and logistics and support command staff in the capability definition process. We are also proposing to involve industry up-front. The reason for that is to identify, as I said, the budgetary, the financial, the timetable and the technical risks. One of the key things we are trying to do at that stage is identify the cost drivers. What we find is that sometimes it is that last five per cent of capability that ends up costing you 20 or 30 per cent of project cost. It is a real pain for us. It is the five per cent that costs you real difficulty and causes delays. Industry tells me it is a pain for them because that is the part of capability that costs them money too.

Senator MURRAY—In shorthand terms, are you saying that pursuing state-of-art technology or capability gets you into unnecessary trouble at times and that a less aspirational program might enable you to better meet capability assessments and avoid excessive cost and risk?

Mr Roche—We can argue about the point at which there is an edge in technology. Certainly it is the case that, if you push it too far or go seeking something that does not exist in the form that you are looking for it at the moment, your risks grow. If you look for something that is just there or coming on stream or where the risks have been identified, then your overall risk has to be a lot lower. But I am arguing against going tried and true; hence the comment about Hugh White’s remark.

Senator MURRAY—I understand, but who makes that judgment? Is it the head of Navy, for instance, or is it the minister?

Mr Roche—This is in change. We are proposing that it be done differently from the way that it is done at the moment. But at the moment there is a process through—

Senator MURRAY—No, I would like to know how it is going to be, not how it is.

Mr Roche—How it is at the moment is that it is simply done through the defence capability committee, which is chaired by the Vice-Chief of the Defence Force who takes responsibility for capability development. Out of that comes a recommendation that goes to the minister and goes to government. The problem with those recommendations is that they tend to be single recommendation solutions rather than options. We are proposing that we open up that process to government rather earlier and go to them before we know what the answer is but when we think we have an idea of what the options are.

CHAIRMAN—But where through that process do you identify, or propose to identify, through-life cost?

Mr Roche—We need to identify through-life cost right up-front, and that is why I said we wanted support command people in at that earlier stage. If we go to government at the stage where there are options, we then commit a proper integrated project team to analysing the option. In fact, for some capabilities, we might have two or three teams in parallel working on different solutions, maybe with different intensity, but right at that stage we use support command people to identity through-life cost.

Senator MURRAY—And is it cost and risk appraisal, not just a cost appraisal?

Mr Roche—No, it is cost and risk—the whole shooting match—and indeed how well it meets capability. Obviously that is the driver. I think we might be diving slightly off the topic, but we are exploring more the use of PFIs—private finance initiatives. That is one of the ways in which you can start to drag your through-life costs under control, because if you put the responsibility on the supplier to provide a significant proportion of through life support then you are asking the supplier to start taking some of the decisions up-front that they should have taken in the first place to reduce your costs downstream.

Mr COX—But that is also a way of expanding the number of options that seem to be available to you now, making a whole lot of financial commitments that will go on and on. If they turn out to be lemons or it turns out that there are too many of them and they do not meet our future capability requirements—

Mr Roche—You have a lot of your budget locked up, that is true.

CHAIRMAN—One of this committee's recommendations is that Australian government purchasing, wherever possible, will be used to support Australian industry and Australian industry development. If you were going to try to off-load the process, to a great extent you are likely to find that we do not have that instant capacity here because we have not built it for anybody else and therefore we buy everything offshore.

Mr Roche—I think that an extraordinary amount of our through-life support is provided by Australian companies. Dr Kearns might have some views on this.

Dr Kearns—Certainly typically in the support phase the overwhelming amount of expenditure—and that might be 80 per cent plus—would be spent in Australia as distinct from the major capital equipment acquisition phase where the amount that is spent in Australia has moved from the 60-odd per cent down to the 40-odd per cent. That has been the range in the course of this decade. Certainly as it moves into the support phase, as you would expect, there is more of an infrastructure for the repair, maintenance and minor modification work that occurs during the support phase.

CHAIRMAN—That is not exactly true, Dr Kearns. We developed a company in Australia which today is called Hawker de Havilland and owned by—

Dr Kearns—The Tenix group owns Hawker de Havilland.

CHAIRMAN—It is owned by Tenix—I was a bit slow getting there—which can manufacture, maintain, refit and build wheels, landing struts and landing gear for the FA18s, yet Defence purchasing can push a button to automatically buy in Washington and have equipment shipped out from the United States.

Dr Kearns—We have choices at the acquisition stage. At that stage, we identify what the Australian industry objectives are, and those objectives are being driven particularly around establishing a capability to provide effective wartime support. That means smart support—it does not just mean a black box out, a black box in. We are not prepared to pay any amount of premium for that, because if we do that our capability takes a dive elsewhere, but we do look for cost-effective industry support. We use the acquisition phase and the leverage we have during that phase to get industry proposals that will set up capabilities in-country that will give us that war fighting support.

Mr COX—Have you integrated into this proposed acquisitions process the sorts of critical paths and requirements that you need to ensure sustainability in a warlike situation?

Dr Kearns—Do you mean in relation to the surge capacity of industry?

Mr COX—Generally, just the capability to keep planes flying in a warlike situation.

Dr Kearns—Yes, we do. I think this is an area where we can and should do this better, but we specify in our industry objectives what we are looking for in wartime support. I mentioned repair, maintain, adapt. Those are particular urgent skills required in wartime. We set those up through the acquisition phase so that they are provided and are there when the system enters operational support. This is not just a statement of intent; that is what we do now. You will find across Australia we have an infrastructure of industry which provides that support and would provide that support in wartime.

Mr COX—Do you understand those things in relation to your existing assets?

Dr Kearns—What we do is we set out the requirements and the bidders will construct a bid based on what assets they have and on what other assets they will need to bring into being. We evaluate those bids against that requirement.

Mr COX—If the F111s were going to be used at a much greater frequency rate for a period, do you know precisely what that would mean in terms of servicing requirements, replacing little black boxes, little pistons in flap actuators and what all of the critical components of keeping them in the air operating at a high level of usage would be?

Dr Kearns—I mentioned earlier that this is an area where we can and should do better. In my view, in the requirements process we do not always see as much definition of those surge requirements in wartime as we would want to see, which we could then use to set requirements on the bidders, on industry. We are seeing that happening now, but not always.

Mr COX—So the answer is no, not that often?

Dr Kearns—Not often enough. We are now seeing that happening in newer projects, but I would want to see that happen more often. If I could come back to an earlier point about some of the ways by which we can manage the risk in the acquisition phase, one of the major risk areas, of course, is software development. This is often a critical concern in being able to achieve delivery. One of the techniques of being able to manage that risk is to not go for the one big bang where you specify an ambitious level of capability for delivery at the initial point where you furnish the equipment but rather to develop a more evolutionary approach, where you develop an initial set of capability, an initial set of software, and then develop that progressively over time rather than try to do it all in one hit. That is one technique which we have been using in software intensive projects and we are getting very good feedback on how that is going.

Senator GIBSON—When we were looking at JORN some years ago, one of the things that came through loud and clear was the rapid change of personnel on the project, leading to obvious inefficiencies and lack of knowledge about what was going on. What are you doing within the department about addressing that problem and actually giving commitment to people on long-term projects to keep them there?

Mr Roche—We are addressing that in the acquisition reform project. There are two aspects to it: the service personnel and the civilian personnel. When I first looked at the problem, I thought it was just service personnel who rotated too quickly and I was quickly put back in my place and told that the civilians rotated even faster. That is sort of true: it actually happens at the lower levels that the civilians turn over faster in between projects. On the civilian side we are doing two things. One is that we are right now exploring a broad banded structure for the Defence Acquisition Organisation which will—and this is addressing another of the Auditor-General's recommendations—provide a career stream in acquisition. The idea is, with a broad band of approximately four classifications rather than the existing eight, that the incentive for job hopping between projects will be reduced and that progress through the bands will instead be competency and performance based. We hope to deal with that at the lower levels. At the higher levels I intend to use—and I have cleared this through the secretary—workplace agreements with senior and key project people to lock them into a project for a particular time with a payment that is related to their retention for the key stages of the project.

On the service side, I have agreed with the three service chiefs and the Chief of the Defence Force that we will again attempt to keep critical service people—and we are focusing on the critical ones—in projects up the key milestones. It will never be practical to keep the one project manager in a project because some of those projects are 15 years plus, but we certainly do not want to be sending out a key project manager just before a critical stage: just before the acceptance of the prototype, just before the signing or the negotiating of the contract, and so on. All three service chiefs have agreed that they will try to synchronise postings into the DAO in accordance with those agreed times. Where they cannot provide a project manager or a key project person that will be there for a significant time, I will look at replacing them with a civilian. If necessary, they are looking at ways of if a service person has to be kept on a project—

Mr COX—Is that a threat or a promise?

Mr Roche—A promise. They will be prepared to contemplate things such as promotion in situ and so on if that is necessary to avoid disadvantaging people. They are also looking within the services to the development of a specialised stream. Certainly Army is heading down this path. Army puts a fair bit of effort into the training of the people who come into the DAO. We do not want people to live all of their service lives in the DAO. Part of their value to us is in fact bringing experience from outside, even from the field. But it does mean that they have the opportunity to do back-to-back postings in the same area; perhaps not doing the same job but in the same area. So we are pretty focused on that at the moment.

CHAIRMAN—My understanding from your annual report 1997-98 is that the Defence Audit and Program Evaluation Committee oversees all program evaluation and audit activities, reviews the department financial statements, and monitors and reviews reports from external agencies such as ANAO and the JCPAA. I also understand that the organisation has not reviewed the Audit reports and not reviewed our reports. Is that true?

Mr Neumann—The audit recommendations and management system database has all reports from 1 July 1998 on it. These are available to members. We also picked up a summary system, which I think went in about two years ago, of internal audit reports. The reports have always been available to members. At I think the last meeting of the defence audit committee, the decision was made that all audit reports, including JCPAA reports, would go out to each member, observer and adviser. I think about a dozen of the internal audit reports have gone out and the ANAO reports are about to go out.

CHAIRMAN—But then what happens? We have been trying ever since I have been on this committee to come to a better relationship with the Department of Defence. It was pretty terrible when I joined the committee. We did not get a lot of straight answers, that is for sure. When you get lied to over and over again—I use that word advisedly; I think it is fair—

Senator GIBSON—Yes.

CHAIRMAN—Lied to, evaded, obfuscated are all good words that probably applied. Then you become very defensive. I guess what I am trying to ask is how much account of what we say does anybody ever take—

Mr COX—Lots, Chairman. They just do not act on it.

CHAIRMAN—Or are we just the thistle under the saddle blanket that will not go away, just a bit of an irritant, but we do not stop the juggernaut from moving on.

Mr Neumann—I am not sure I can actually answer all those questions, but let me try. The putting together of the ARMS database collected for the first time—I would not argue it was in a user-friendly way but at least in a consolidated format—the recommendations of audit committees right across the board. That also gives the ability for those who are interested to look at what the trends are over time. We have only got, as I said, just under two years worth of data.

The follow-up is actually brought to the committee's attention, where people have not followed up. For example, tomorrow's audit committee will in fact have another look at the high priority ones that have not been followed up and do not have a completion date, or where managers have just written 'in progress'—that came up at an earlier committee this year or late last year—which is clearly unsatisfactory. To say 'in progress' does not give you a milestone or anything to measure against it. If you wanted to take a while, it could be 'in progress' for 10 years, if you liked. So those sorts of measures are taken.

The other issue is that on about 4 May I signed a contract with Paul McGrath to be the independent chair of the audit committee. I have had discussions with him today. He will chair his first meeting tomorrow. I think you will find a much firmer approach to making group managers responsible for those recommendations that they have agreed. Those that are not agreed obviously will not be followed up. Those that are agreed or agreed in principle or with qualifications will be followed up much more rigorously.

Mr COX—What is his background?

Mr Neumann—He sits on a couple of audit committees. He is the chair of the National Electricity Market Management Company's audit committee, and the Prudential Liability Committee and also the remuneration committee of that one. He is also an independent member of the Audit Committee of the Commonwealth Department of Transport and Regional Services, and he was the chief executive or director, if you like, of the Australian Maritime Safety Authority. He was Chief Executive of the Engineering and Water Supply Department of South Australia and Commissioner of the Murray-Darling Basin Commission.

Mr Roche—I thought I might mention that he is an engineer, Mr Chairman—an essential fact that my colleague forgot to mention.

Mr Neumann—He is also a Fellow of the Institute of Engineers Australia.

CHAIRMAN—He is a good fellow well met then, isn't he?

Mr Neumann—And a member of the Institute of Public Administration Australia.

CHAIRMAN—Excellent.

Senator MURRAY—Who does he report to?

Mr Neumann—He reports direct to the secretary.

Senator MURRAY—And the secretary to the minister?

Mr Neumann—In the sense of ?

Senator MURRAY—I want to know that, if the progress is unsatisfactory or needs to be reported on , the secretary will take note and the minister will take note, or it will come back to the ANAO or it will come back to this committee but that in some way there is a focus on it.

Mr Neumann—My understanding is that the secretary in fact is the responsible officer to make sure things happen at the end of the day. He is responsible for the ethical, efficient and effective use of resources under the FMA Act. So my interpretation of that would be that the buck stops with the secretary.

Senator MURRAY—That is fine. The buck may stop with him, but that does not guarantee that he will be reporting to anybody. That is the issue, that progress is made. Is there a formal method by which quarterly, or periodically or in some way, there is an official reporting on progress of these recommendations to somebody who is going to say, 'Well, why hasn't it gone further, or what is happening?'

Mr Neumann—Recently, at the end of every DAPEC meeting—and recognise that we have changed chairpersons—the chairman has reported to the secretary on the substance of the discussions at the meeting. The second issue is that, in terms of the financial statements, I know of at least two occasions where the Australian National Audit Office has reported directly to the minister.

CHAIRMAN—ANAO noted that in relation to the new submarine project there were no references to be found on lessons learned for DAO itself. In addition, the ANAO found no evidence that issues identified in ANAO and JCPAA reports on Defence acquisition projects were being taken into account by project managers. Is this going to be addressed, Mr Roche?

Mr Roche—It is, and has been, addressed.

CHAIRMAN—The audit committee is not necessarily enough. Does it get down to project level, to systems engineers? If we find something of value—and I would note that, while we did not get the publicity and McIntosh-Prescott did, our report on the subs was essentially not substantively different from the McIntosh-Prescott report, except for the periscopes, which got missed. But that was about all, as I remember.

Mr Roche—Yes, I would expect the audit committee to get down into the detail from time to time, but I would also expect them to be pressing me and my division heads on what is coming out of projects and out of audit reports. Certainly, all that the Audit Office and your committee have brought to light on project management within the last 10 or 15 years is being taken into account in the development of a comprehensive package of acquisition reform. So, in a sense, we are hoping to draw a line. A lot of it is in the past. Maybe it has not been obvious, but I have found that many of the procedures in place in the DAO were put in there in response to problems in previous projects, which were identified both by your committee and by the Audit Office. In a sense that was part of the problem: there were too many additions to process to pick up problems without necessarily going back to zero base every so often.

CHAIRMAN—There are always going to be problems, Mr Roche, and this committee recognises that. But the Audit Office talked about risk management. We accept the fact that there are risks to be taken. We do not want you to have a risk averse culture; we expect something to go wrong at some time. You are not perfect, so it is not our job to just sit here and criticise you constantly. But when, systemically, we see the same problems over and over again we have an obligation on behalf of the parliament to investigate those issues, bring them to your attention and demand that something be done about them.

Mr Roche—I accept that. Mr Chairman, I am conscious of the fact that you are worried about our views on the extent to which the recommendations of your committee and the Audit Office are taken up, and I wonder whether it would be useful for us to go through the six recommendations quickly, just to outline where we are.

CHAIRMAN—Yes. I was going to ask you whether, perhaps, your response to ANAO's recommendations would be different today from what they were when this report was printed?

Mr Roche—Yes, it is in some respects. I think it would be useful to actually make that point here so that you know we are not simply ignoring things and that some things have changed.

CHAIRMAN—Thank you.

Mr Roche—For example, under recommendation 1, the ANAO recommended that we consider the benefits of allocating capability output budgets to the relevant output managers who, in turn, would fund the functional groups through purchaser-provider arrangements. We do agree that the acquisition project team should be funded on a purchaser-provider basis. We are trying to put in place the arrangements by which that is done. I have to tell you that it is not easy to do it. I believe we could be trying to fund up to three-quarters or, maybe, 80 per cent of my organisation on a purchaser-provider basis. To do that with projects that come in waves and to maintain the skill bases within the organisation is going to be a work of some art. It also means that I have to break through the three-pot funding system we run at the moment, where projects are funded—and the Audit Office reported on that—out of my base level funding, which covers a lot of the rations, supplies and salaries, the project funding, which is often used to fund professional service providers, additional travel and so on, and, of course, the service people, who form about a third of my organisation and who come as a free good. I am proposing that the project manager get funds to cover all three things up front and to get it through the DCC.

That means we have to change a number of things, including the way in which we fund service personnel in the department. So is not something we can do lightly.

CHAIRMAN—How many people do you have altogether?

Mr Roche—We have about 2,200 at the moment, of whom about 550 are service personnel.

Dr Kearns—The current number of permanent personnel would be about 1,900, of whom about 1,350 would be Public Service staff, about 550 would be Defence Force personnel and then there are some professional service providers.

Mr Roche—Yes. There are 200 to 300 service providers. I factored them into that headcount, so the number is about 2,200.

Ms GILLARD—Is the professional service provider a consultant?

Dr Kearns—It is under a contract. A consultant tends to be more providing a review of a process. A professional service provider actually does a line job; it might be a training task or a documentation task that might not otherwise be done.

Mr Roche—A lot of them are engineers, for example.

Ms GILLARD—So they are not reported as consultants in your annual report in that budget.

Mr Roche—No.

Ms GILLARD—So their costs are reported where?

Mr Roche—They are in our total budget, but they are not reported separately. We agree with Audit that our team should be funded on a purchaser-provider basis, and we are attempting to do that. Realistically, it is going to take me 12 to 18 months to get to the stage where we can effectively do that. What we do not propose to do is to give the funds to the output managers. Because the funding is allocated by the DCC and by ministerial decision, we do not actually leave output managers with a permanent pot of money that they can use to fund or not fund capability.

When Army, for example, are providing armed reconnaissance helicopters, the funds for that go to Army for that specific purpose. The output manager does not have the decision making ability to decide that he will spend it on armed reconnaissance helicopters rather than armoured personnel carriers. That is not a decision that the output manager makes. That is made by the Defence Capability Committee and by government. In a sense, we could give the money to the output manager, who would then pass it straight to the project team, and we do not see the point of that third step. I think the essence of the recommendation has been picked up but not the precise allocation to output managers.

The second recommendation went to budget carryovers. I wish I was so lucky as to have a budget carryover at the moment. Again, the essence of the recommendation is that we have the money available in years appropriate to the progress on the project so we can spend sensibly without advancing money against the project. I can assure the committee that there is no risk of advancing money against any project at the moment, but there has been a review of our funding undertaken by the Department of Finance and Administration, and one of the proposals that they have made and that we are looking at is that there be a new way of categorising our capital equipment budget and that that be provided in a phased way rather than an even amount year on year so that we try to manage the peaks and troughs. They are suggesting that it might be provided over the five-year program, with the peaks and troughs reflected in the actual budget allocations. If that were done, it would take away the need for the carryover arrangements, which in any event had been freed up. So again we agree with the thrust of the recommendation; the actual implementation of it, though, will be slightly different, I think, from what Audit had in mind—and that was because there was a finance review done after the audit review.

CHAIRMAN—Are you happy with that, Mr McPhee?

Mr McPhee—Indeed.

Dr Williams—Could I clarify: with accrual accounting, there is essentially no limit now to the cash we can carry over. So to some extent that overcomes the problem.

CHAIRMAN—I understand that, but some of the old mentality still exists. As I told the Audit Office earlier, as a building contractor I very frequently got requests in June from architects and project managers, from both the Commonwealth and the state of Victoria, to put in big progress claims in June, because they wanted to pay quickly to get rid of their money—whether we had done the work or not. It was not fraud, but it was a way of managing the budget process which is totally inappropriate.

Mr Roche—I understand the problem completely.

Senator MURRAY— When you are talking about peaks and troughs, you are talking about peaks and troughs in expenditure on an acquisition which is under way, aren't you?

Mr Roche—Or which is proposed.

Senator MURRAY—I can understand it for an acquisition which is under way, because the component expenditure will vary year by year. I get a little more concerned when it is a proposed acquisition. Typically a commercial organisation would create a reserve knowing that in five years time or whatever it might need to refurbish the factory or buy something. Are you not accepting the reserve idea, or what is it you are saying about proposed acquisitions funding?

Mr Roche—I am saying that we have managed to hold our capital acquisition expenditure at probably averaging $2.4 billion or $2.5 billion for some 10 or 15 years. That is probably a bit artificial in terms of the real life demand for funds as major projects come on-stream and there should be some peaks. In looking at our forward planning, I can see peaks now where Air 6000 cuts in. I am negotiating a contract right now with Boeing for AEW&C, and that generates peaks. Some of the peaks within the Boeing contract are not that enormous in terms of our total budget, but if they happen to coincide with another peak then they can drive the total funds requirement. What Finance is saying is that, if in year 3 I really need 3½ billion, not 2½ billion, but in the following year I only need one, that is the way the money should be allocated.

Senator MURRAY—But a commercial organisation would treat that in one of two ways. It would say, ‘Look, I’ve got a lumpy expenditure which will occur in such and such a year,’ and it would either create a reserve and build it up sufficiently at that time to be able to meet it from its own funds or enter into a debt and financing capacity to do so. If we have moved on to accrual accounting, which is essentially a commercial mechanism for appraising the accounts of the Commonwealth, why wouldn’t we approach it on that commercial basis?

Mr Roche—My short answer is that in a sense we are and that what we are using is the department of finance as the banker in this equation rather than us having a hollow log within the department. Dr Williams might want to make a further comment on that.

Senator MURRAY—I am searching to get the terminology and the language equivalent. For decades, if not centuries, national accounting language has been different from commercial accounting language. We are now bringing the two together, but still in this country we talk about surpluses, not reserves. We still talk about methods of financing which use old language and not new commercial language. That is why people like me have problems in understanding when you are describing a financing mechanism.

Mr Roche—I would have to say that the system is not purely commercial. I understand commercial systems very well and I know exactly what I would be doing in the commercial world in terms of funds management, cash flow budgets and managing depreciation and so on. I understand that perfectly well, but I do not have all the flexibilities that I would necessarily have in the commercial world and we are, to a certain extent, fudging the system, I suppose.

Senator MURRAY—But at the core, if I can pursue this with you, my question to you is surely that you are making your funding for a lumpy expenditure either from a reserve—in other words, one that has been accumulated over time—or from debt wherever that originates. Will your accounting expression of that situation be in those terms?

Mr Roche—That is an excellent question. I do not know the answer to that. I do not know how the different allocation would be reflected in our annual accounts.

Dr Williams—Perhaps I could see if I could answer that fairly broad question. We are really in a stage of some transition still, I would argue, from cash to accruals. Whilst we have our operating statement, balance sheet, et cetera and we are managing now both budget and reporting in full accruals—and so we record depreciation, et cetera—our budget is still really pegged to a cash level and normally the reporting would be, for example, zero cash growth in the budget. The result of that is that the government funds us through two appropriations. One is the basic cost of outputs. That covers depreciation, et cetera—and you are right: over time that should build up a backlog of funds to cover some future needs. We also get an equity injection. At the moment that equity injection, which is put into capital, is simply a balancing line; it brings the budget up to zero per cent. The sorts of models we are looking at with the department of finance are to see whether that equity injection perhaps ought to fluctuate over time to pick up some of the peaks and troughs. In other words, there may be times where you would have a lower cash budget and at other times a higher cash budget, rather than what is at present both a cash and an accruals constraint on where we are going.

The other point I would raise with respect to the accumulated depreciation is that the problem we have, having come in at a snapshot in time and picked up accrual budgeting, is that we have not got the backlog of depreciation expenses going back in time, so it is very hard to suddenly find the money. So in a sense I think, as Mr Roche said, we are really relying on Finance as the banker, if you like. If we could get some more flexibility on the equity injection, that would clearly give us some more scope to deal with the peaks and troughs.

Senator MURRAY—So in your books they would be recorded as the source of your debt?

Dr Williams—There are a few ways to go. The way I think it would run would be that we would actually have our appropriation from government varying over time. On the basis that government could borrow at a better rate, if you like, than we can get on the private market, it would make sense for government to vary our appropriation. To do that, they would need good visibility of our capital program and be able to make judgments about the priorities in order to make a variation; in other words, to move away from a simple zero growth budget to something which reflected the variations. If I can make one final point, though, as well as the problems of depreciation and the fact that we do not have a backlog of funds because we have only come in at a certain point, the other problem is that there is fairly clearly established evidence that the cost of military equipment rises in real terms, sometimes by many per cent real per annum, so that the depreciation will never be enough to cover the cost. A good example would be the Oberon submarines. In terms of comparing the cost of an Oberon with a Collins or an equivalent modern submarine, you would need to have increased the cost of the Oberons by probably five, six, seven or eight per cent per annum. So if you had merely had the depreciation component, it would not buy one submarine in the new scheme of things. Again, it gets back to the equity injection being the important balancing line and, if we can get more flexibility to deal with peaks and troughs, that probably is one solution.

Mr COX—As technology changes, you do not actually have to replace every capability that you have ever had with an equivalent version.

Dr Williams—Indeed.

Mr COX—There is a tendency among the services to try to do that because they have their little empires.

CHAIRMAN—Boys and their toys.

Mr COX—Yes.

Mr Neumann—But there is a limit to the trade-off against numbers. After a while, essentially you have to make a decision, in my view, to come out of the capability because your numbers become so small that they are not useable. Even at a relatively small attrition rate you can quite quickly go through a couple of dozen aircraft if you ever have to use them on operations.

CHAIRMAN—Why don’t you sell your services to the enemy not to shoot?

Dr Williams—To put it in perspective, if we took the depreciation on the Oberon submarines, you could not buy anywhere near one Collins submarine with the amount of money, such is the real growth in the cost of technology.

Senator MURRAY—Which means you need debt.

Dr Williams—Yes, or an increased appropriation flowing from government.

Senator MURRAY—That is right. If it is going to be an increased appropriation, the question is whether it comes out of surpluses which constitute reserves, whether it comes out of debt or whether it comes out of an increased cash appropriation from current revenue.

Mr Roche—Indeed. Part of the problem is that, for example, we are seeing the DDGs out of service now after some 30 years. With some of those ships we probably have the equivalent of two years depreciation on an asset that has been in service for 30-something years, which is clearly not sufficient to help us out over the interim period.

Ms GILLARD—Before we move to recommendations, I do not think we got Mr McPhee’s response to what you said about recommendation No. 1. I think you responded on recommendation No. 2 , but not recommendation No. 1. Have I completely confused you?

Mr McPhee—I think it is a very significant and noteworthy shift in position and I think it would be useful. I think we would say, accepting Senator Gibson’s point, that in the longer term there is some value in keeping an eye on recommendation No. 1 because of the trade-offs that output managers do have to make, but at the moment I think it is obviously premature and this is a substantial move in the right direction.

Mr Roche—We simply do not agree at this stage that an output manager who is in a position for two to four years can make some of the decisions that are going to be coming to roost 15 years down the track.

Senator GIBSON—I am thinking that on this committee we would like to return to this at some point just to review that.

Dr Williams—If I could make a comment; I would observe that beyond the acquisition organisation, we are now quite actively looking at purchaser-provider models more widely across Defence. So I think that aspect of this has been well and truly picked up and we would hope over the next 12 months or so to be moving fairly quickly in that direction.

Senator GIBSON—That is good.

Mr Roche—Recommendation No. 3(a) is about provision of regular reports on equipment acquisition projects. The short answer is that we agree, and we are in the process of doing it. Recommendation No. 3(b) is that output managers:

... have authority to intervene in project management in accordance with agreed protocols and to implement contingency measures in response to adverse variations from scheduled progress, cost and quality ...

That is not compatible with expecting me to accept responsibility for what the project manager does.

Senator GIBSON—It is the other side of the coin from No. 1, basically.

Mr Roche—It is a slightly different one in the sense that the project managers report to me and I take responsibility for what they do. If a person can come in from outside the organisation and direct them, implement contingency measures and so on, then they have to take the responsibility for the project, not me. That might mean that you can dispense with my position and we just have a bunch of project officers for hire.

CHAIRMAN—But you did tell us that decisions would be made on a logical basis by a committee that would include a representative of the Defence chief.

Mr Roche—Absolutely, of the output manager. That is a service chief as opposed to the Chief of the Defence Force.

Dr Williams—Chairman, could I just make an observation here that might help to clarify the role of the output manager? I think it is worth distinguishing between the current force and the future force in this regard: that the current force is essentially operating and getting best effect out of our current capabilities. In that respect, I think the output managers—the chiefs, essentially, for the services—have a very clear role. It is really their business to deliver the capability. With respect to the future force, they also obviously have an involvement in terms of understanding operational aspects and providing advice. But it is important with the future force, where we are planning for 10, 15 years, that we have a joint perspective. So it is important that we are making the trade-offs not simply within single output manager areas but across; that is, trade-offs between aircraft and ships and the like. So it is important I think that we do not overstate the role of the output manager in the future force. I think we need a more joint focus for that.

CHAIRMAN—You would not disagree with that, would you, Mr McPhee?

Mr McPhee—I would not think so.

Mr Roche—Recommendation No. 3(c) is:

... provide, for consideration by Defence senior management, reports on major equipment acquisition projects disclosing any adverse variations from approved tolerance limits on scheduled progress, cost and quality, together with advice of any action considered necessary in the circumstances.

We agree. We are just discussing how that will be done internally.

Recommendation No. 4 is that Defence supply the DAO's standard project management method to all groups involved with capital equipment acquisitions. That has been agreed by the department.

Recommendation No. 5 I think brings us back to No. 3(b) again. It states:

The ANAO recommends that, to better align equipment acquisition project team focus with customer needs, Defence consider making Project Boards accountable to the Output Manager responsible for delivering the relevant output.

Again there is that issue of control. I do not have any difficulty with the idea that DAO must be accountable to the output manager for our performance, but there is a difference between accountable to them for our performance and having them exercise control over the project team.

CHAIRMAN—Do you have any problem with that, Mr McPhee?

Mr McPhee—Certainly under the model Defence is working to now, I agree with what Mick Roche is saying.

Mr Roche—Recommendation No. 6 states that:

... DAO, in consultation with Output Managers ... maintain its personnel strategic plan as a workforce plan that brings together its current personnel and workforce initiatives and manages workforce demographics to increase the availability and continuity of experienced project managers ...

and so on. Yes, we agree. That is going to be a difficult task. We are already into it and it is not easy. My suspicion is that it might be well over a year before we are able to come back and say, ‘We think we’re winning on this one.’

Mr COX—There is the supplementary DAO response to the contracting inquiry that you have put in.

Mr Roche—I propose to put in a further supplementary one, if that is acceptable to the committee.

Mr COX—That would be good.

Mr Roche—That was submitted in my absence.

Mr COX—I did not think that it really covered all the issues.

Mr Roche—No. At the moment a further one is in preparation that goes to the issues we discussed about areas in which we believe access is appropriate and so on. In fact, it suggests a way in which the legislation might be amended to take account of it.

Senator MURRAY—I have a short question. When do you suggest that ANAO go back to you to do a full audit again?

Mr Roche—Mine is a three-year contract, and I would be delighted for them to come back! We are talking with ANAO about this acquisition reform project that we are on, and I would be happy for them to make a judgment—in the light of the sort of things we are doing in that reform program—about when they want to come back. To my mind, there would be not a lot of point in it under 12 months or so from now. But in 12 to 18 months from now it might be that a progress report is timely.

Senator MURRAY—Yes. Because there is such sensitivity and interest in this area, and they need to report to the parliament, I would have thought that 18 months to two years would be appropriate.

Mr Roche—We would be very comfortable with that. It is not all going to be done by then, but you would want some pretty solid evidence by then of whether or not we are succeeding.

CHAIRMAN—You do understand that we are keeping a watching brief on both JORN and Collins?

Mr Roche—Yes, I understand that. You are visiting JORN in Adelaide?

CHAIRMAN—No—in Melbourne.

Mr Roche—Yes, in Melbourne. I am aware of that.

CHAIRMAN—We are going to go over its software development.

Mr Roche—We are a lot happier with the way that project is going.

CHAIRMAN—On behalf of the committee, we were quite impressed when we went to Longreach with what we hoped the ultimate capability will be. We are currently starting an inquiry into Coastwatch.

Mr Roche—Fortunately I will miss that one. It was my alma mater: that is where I came from, in Customs.

CHAIRMAN—We are starting an inquiry into Coastwatch, which will take us back into Defence again, since Defence supplies some of the assets that are used by Coastwatch. But certainly JORN would make a difference to the operation, too, if we had it operational. So we will continue to ask questions about when it is going to work and whenever it will come to pass.

Mr Roche—I think it is getting very close. We might be talking about slippage of a few months, but nothing of significance compared to what has gone before. Considering the challenge facing the people who took it over, I think it is in very good shape. One of the big problems we have in DAO is of course that as these projects eventually come good—and JORN is one that is coming good; and I believe that we will get Collins up to speed too— we are not actually in a position to say how good they are, because what JORN can eventually do is not going to be a subject for public discussion.

CHAIRMAN—Of course not; we understand that. As Mr McPhee has no further comments and the committee has no further questions, we thank you very much for your attendance and your information, gentlemen. If we have further questions, you will be happy for us to ask them in writing, won't you?

Mr Roche—Absolutely. Thank you, Mr Chairman.

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

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 3.33 p.m.