



HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND
PUBLIC ADMINISTRATION

Reference: ANAO Report on guarantees and indemnities

CANBERRA

Monday, 16 June 1997

OFFICIAL HANSARD REPORT

CANBERRA

HOUSE OF REPRESENTATIVES
STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND
PUBLIC ADMINISTRATION

Members:

Mr Hawker (Chair)

Mr Albanese

Mr Anthony

Dr Southcott

Mr Causley

Mrs Gallus

Mr Hockey

Mr Latham

Mr McMullan

Mr Mutch

Dr Nelson

Mr Pyne

Mr Willis

Mr Wilton

Matter referred to the Committee:

Review of the Auditor-General's audit report No. 6 of 1996-97 - Performance
Audit - Commonwealth guarantees, indemnities and letters of comfort.

WITNESSES

**DOLAN, Mr Martin Nicholas, Assistant Secretary, Finance Branch,
Department of Primary Industries and Energy 101**

**MITCHELL, Mr David Bruce, Director, Administration and Accounting
Policy, Department of Primary Industries and Energy 101**

**MOORE, Mr Kenneth Lindsay, Assistant Secretary. Resources Policy and
Programs, Department of Defence, Russell Offices, Canberra,
Australian Capital Territory 110**

**LEAK, Miss Dianne Chave, Director of Costings Policy, Department of
Defence, Russell Offices, Canberra, Australian Capital Territory 110**

HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON FINANCIAL
INSTITUTIONS AND PUBLIC ADMINISTRATION

Audit Report No. 6—Commonwealth guarantees, indemnities and letters of comfort

CANBERRA

Monday, 16 June 1997

Present

Mr Hawker (Chair)

Mr Causley

Dr Southcott

Mr Mutch

Mr Willis

The committee met at 9.35 a.m.

Mr Hawker took the chair.

CHAIR—I declare open this hearing of the House of Representatives Standing Committee on Financial Institutions and Public Administrations's inquiry into the Australian National Audit Office Performance Audit No.6, entitled 'Commonwealth Guarantees, Indemnities and Letters of Comfort.'

This is the fifth hearing this committee had held since it commenced the inquiry in late 1996. The committee has already heard from the Audit Office, the Departments of Finance, Industry, Science and Technology and various other government agencies. This public hearing is likely to be the final hearing in this inquiry and drafting of a report will commence shortly.

The audit report has identified significant shortcomings in the management of guarantees, indemnities and letters of comfort by a number of government agencies. Poor management of these instruments has resulted in a number of costly claims against the Commonwealth in the past.

At today's hearing the committee will be hearing from two government departments responsible for administering several Commonwealth contingent liabilities, namely the Department of Primary Industries and Energy and the Department of Defence.

The Department of Primary Industries and Energy administers very significant Commonwealth loan guarantees, including those for Wool International and the Australian Wheat Board. In contrast, the Department of Defence administers a large number of indemnities. The committee looks forward to hearing the views of these departments on the issues raised in the audit report.

I welcome representatives of the Department of Primary Industries and Energy. Before commencing our questions, I remind you that the evidence that you give at the public hearing today is considered to be part of the proceedings of Parliament. Accordingly, I advise you that any attempt to mislead the committee is a very serious matter and could amount to a contempt of the Parliament.

[9.37 a.m.]

DOLAN, Mr Martin Nicholas, Assistant Secretary, Finance Branch, Department of Primary Industries and Energy

MITCHELL, Mr David Bruce, Director, Administration and Accounting Policy, Department of Primary Industries and Energy

CHAIR—Do you want to make a brief opening statement before I invite members to proceed with questions?

Mr Dolan—There is nothing I would like to say at this stage, Mr Chairman.

CHAIR—In the 1997-98 budget, the statement of risks reports the Commonwealth's loan guarantees. While the Department of Primary Industries and Energy records both the principal covered and the balance outstanding in its annual report, the statement of risks does not. Is the Department aware of any reason why both values are not included in the statement of risks? Would not the statement of risks be more accurate if it contained both of these?

Mr Dolan—I was not aware of that one. Your concern is that at the moment we are only covering interest repayable?

CHAIR—You have principal covered and the balance outstanding. Those are in the annual report but not in the statement of risks.

Mr Dolan—The statement of risks only covers balances.

CHAIR—Loan guarantees. The question is that this really is not consistent.

Mr Dolan—Reporting on those matters for the budget is not undertaken by our department. We supply the information which is consistent with information on our financial statements. It is undertaken by the Department of Treasury, isn't it, Mr Mitchell?

Mr Mitchell—Yes, that is right.

Mr Dolan—So we will have to refer that issue to them, I am afraid. We can easily get back to you with an explanation.

CHAIR—If you could, we would certainly appreciate a response on that. Coming to the Audit Office report itself, it contained many recommendations to which your department would be expected to respond. Are you happy with the Audit Office report and recommendations? Do you have any comments or additions to make or is there anything that you find difficulty in responding to?

Mr Dolan—You will note from our initial response to the report's recommendations that we made no comment on those recommendations which related to the Department of Finance. We did not see that as necessarily our province. I suppose our only particular concern is that sometimes the positions taken by central agencies do not fully reflect the individual operating requirements of departments. The Department of Finance these days is reasonably effective in making sure they take account of those, but we would wish for that to continue in the application of the various specific recommendations for whole of government approaches to guarantees and indemnities.

The report itself, we find, is like a number of performance audits very useful in showing good practice across the Commonwealth. In some areas we are pleased to note that our department represents good practice. It has helped us review some of the areas where we could definitely improve the way we do things. We are working through those at the moment as a department.

CHAIR—What were some of the specific difficulties that you saw? You said that when they apply across various agencies, they do not always take into account particular cases that you see in your department. Would you like to expand on that area?

Mr Dolan—There is a tendency from time to time for central agencies, including the Department of Finance, to come out with a prescriptive set of rules: this is the way to respond to a particular set of circumstances. We have a department, as you are aware, that covers a quite dramatic range of policy and program arrangements, and probably the largest range of statutory bodies in the Commonwealth. As a result the 'one size fits all' approach is something that from time to time can give us concern.

I would not make too much of this comment. It is just that we like to encourage our colleagues in the central agencies when they are developing guidelines to take account of the practicalities of implementing them on the ground.

Dr SOUTHCOTT—Have you read the Department of Finance circular for this year which relates to indemnities, guarantees and letters of comfort?

Mr Dolan—Yes.

Dr SOUTHCOTT—Would you care to comment on the guidelines of the new circular.

Mr Dolan—I will make some initial comments, Dr Southcott, and then I might pass the matter to Mr Mitchell, who is responsible for the details of our internal accounting instructions and so on.

My initial view of the latest Department of Finance material is that it is much clearer; it is a very well written document that actually specifies, at least in broad, the full range of things that we have to cover off. We see it as a good response to the sorts of directions that were set out in the audit report. The real question for us is as to the extent

we need to make our internal directions more consistent with what is now the central government policy. We feel we are still complying reasonably well, but Mr Mitchell is better on the matters of detail.

Mr Mitchell—Certainly the guidelines provided by the Department of Finance are useful. We have used them to update our accounting package which we circulate to all the program managers within the department. I think it more specifically helps them identify some of the definitional issues that we have to deal with in making an assessment as to whether we have these sorts of instruments within the department, bearing in mind that our guarantees are limited to four and we only have one indemnity in the department. It has to be recognised that we do not have a huge coverage of these sorts of issues within the department anyway, but it still provides us with a useful information base to go out to them and explain the sorts of issues involved.

We certainly will be using them to update our secretary's instructions that apply to the department, but generally speaking I think they are pretty good and useful.

Dr SOUTHCOTT—That aside, do you consider that the Department of Finance is useful in assisting you in managing the indemnities and guarantees?

Mr Mitchell—In terms of providing information that can assist us identify these instruments if they exist, yes. In terms of actually managing, that is something that we have to take responsibility for in the department. We certainly welcome some overall guidance, but in terms of being prescriptive, as Mr Dolan has already mentioned, we prefer to manage the issue more specifically ourselves under some general guidance from DoF.

CHAIR—You mentioned that you had four guarantees, is that right?

Mr Dolan—That is right.

CHAIR—Of course, there are a lot of other areas that fit into the audit report. When the ANAO recommended all agencies conduct a review of their records to ensure that they had a complete register of all guarantees, indemnities and letters of comfort, did you find any more instruments that you had not reported before or had not recorded before or that you were not aware of?

Mr Dolan—The only one we picked up—and it was a useful test of how things were working—was the new indemnity that we had to do with the Maralinga clean-up, which demonstrated at least that the system was working. Our review process automatically turned up the only new indemnity that we had entered into over the period. We have an annual review which relates to our annual financial statements process, which goes into considerable detail in the department on the range of contingent and other liabilities. That, we have found, has successfully picked up the range of guarantees and

indemnities. I could not be—and I suspect no other department could be—absolutely 100 per cent sure on letters of comfort, given the range of potential matters that arise there. But to the extent that anyone can be certain on those, given the imprecision of what letters of comfort might actually be, we are confident that we have covered off the liabilities that we have entered into on the part of the Commonwealth.

Mr Mitchell—May I also add that our financial statement process is extremely rigorous in its approach to all matters of disclosure for the annual report and financial statements. This is just one of those elements within that particular approach. In essence we take an approach of a pre-audit in gathering the information prior to ANAO's audit of the financial statements. The Australian National Audit Office—ANAO—also regards the department's practice as being among best practice in the Commonwealth with regard to financial statement preparation, so we are extremely confident that we do a very good coverage. Internally we also require our senior program managers to sign off a statement of disclosure in terms of the balance sheet and off-balance sheet items which are required to be picked up in the financial statement process. That also assists in driving home the disclosure requirements of these sorts of issues within the financial statements.

Mr CAUSLEY—I note that you have got a couple of ticks out of the Audit Office. That is something but I wouldn't preen myself too much over that, I suppose. You are one of the vital areas of government, there is no doubt, so far as trade and so on are concerned, and I may not fully understand just how the system works, but undoubtedly you are also one of the big risk areas of government because of the large sums of money involved. In the past we have had some pick-ups, we have had some failures, and that is expected, I suppose, but how do you assess the risks involved? Is it from past experience, and what type of actions do you take to try to reduce the risk to the overall taxpayer?

Mr Dolan—It is to a large extent a case by case approach. We do have a regular risk assessment process which relates to our development of a control framework, but it has a broader approach to the risk that the department is exposed to. I think a useful example of the approach we take is the Maralinga contract, which is our only existing indemnity. What we assessed there was the extent to which we could usefully expect contractors to cover their risks, which is fundamentally a matter of potential exposure to radiation by people working on the clean-up of the Maralinga test site; to what extent the contractors could be expected to pick up the risks through their own insurance policies.

My recollection—and I am sure Mr Mitchell will correct me if I go too far astray—is that the contractor, Geosafe Australia, covers risks up to \$10 million and the Commonwealth has indemnified them for the rest. We examined such limited court precedents as there were to find out what sort of exposure existed, and therefore came to what we thought was a reasonably good estimate of somewhere between \$800,000 and \$900,000 per person as the sort of level of risk if we were taken to court over these sorts of matters.

That combined with an assessment of the actual risk, given the practices and so on used in the clean-up process, was taken into account and the requirements on the part of the Commonwealth to ensure that good health and safety practices were happening and so on. That was a major balancing item and in the end I think there was a good solid policy risk basis for determining that the Commonwealth should enter into an indemnity. The documentation was put in front of the minister, who remained fully informed of the sorts of matters that we were taking into consideration. That is the sort of approach we would be intending to take in the department.

Guarantees are somewhat different. Guarantees are under legislation and effectively there is a whole series of hoops we have to leap through for the Treasurer before the Commonwealth will guarantee loans—for example, to the Wheat Board or to Wool International.

CHAIR—You mentioned \$800,000 to \$900,000 per person. How many people are we talking about here and how did you arrive at that figure?

Mr Mitchell—The public insurance liability coverage is \$5 million. They have assessed the likelihood of a claim exceeding that \$5 million threshold. They used a particular court case a couple of years ago where they looked at the amount awarded to the claimant for insurance on this particular issue. They took that particular coverage and they expect that 17 people will work on the site for the duration of the clean-up process. They use the award against the number of personnel as determining the overall mutual liability in this particular instance. They are looking at roughly \$13 million as a potential ultimate liability.

Mr Dolan—The basis was a court case in New South Wales, Johnson versus the Commonwealth, where the Commonwealth lost on the basis of a claim that was related to radiation damage to an individual and therefore based on the size of the compensation paid. We used that as a starting point for determining the sorts of liabilities to which potentially we could be exposed.

Mr Mitchell—This was taken in full consultation with the legal advisers as well in determining what the likely liability would be for the Commonwealth.

Mr CAUSLEY—You are saying that there are many hoops to jump through in terms of the Wheat Board, Wool International and so on. I take it from that that you put forward to cabinet a risk assessment of any new customer, or even old customers because circumstances change—and of course we are talking big money here, some hundreds of millions of dollars—and it is then up to cabinet to decide whether that goes ahead, is that what you are saying?

Mr Dolan—No, it is a stage earlier than that—the initial assessment of the extent to which the Commonwealth should cover the overall borrowings of the body. The

individual commercial decisions are the province of the statutory body itself. While the department will provide advice to the minister, the decision making is for statutory bodies and is at arm's length from the department as such.

So it is a matter of to what extent in the first place the Commonwealth should underwrite the loans entered into by a body.

Mr CAUSLEY—So the individual assessment of a customer comes back to the statutory body?

Mr Dolan—Yes.

Dr SOUTHCOTT—With regard to Geosafe Australia, you said that when you got the original indemnity there was no commercial insurance to cover people against nuclear exposure. Do you review that to see if there ever is any insurance that does become available?

Mr Dolan—There was limited cover. Yes, we would review that in due course, and each time we would get to the stage of reviewing the contract and that is one of the things we would take into account.

Dr SOUTHCOTT—Are you confident that you have captured all the indemnities and guarantees to which you are exposed? The Audit Office report was concerned that they may not have found all the indemnities and guarantees?

Mr Dolan—I couldn't give 100 per cent guarantee, and I am not sure that any department could, given the length of the history and the things that could be lurking around from 20 to 25 years ago. We are picking up stuff that goes all the way back to the setting up of the Snowy Mountains Hydro-electric Authority. We are as confident as we could reasonably be that we have picked up all the guarantees. The guarantees we know. Indemnities we are pretty sure we have got.

Mr CAUSLEY—Some guarantees could be implicit.

Mr Dolan—Well, that is certainly true. It is very hard to get a fix on that sort of thing in any financial sense. In terms of a lot of those, the only time you can truly bring them to book is as a contingent liability as a result of prospective court action. Until then one is not aware necessarily that such a thing exists. An example there is the current court case over the Helix contamination of cotton trash fed to cattle. The decision making process there, once you follow it through, was quite complex. The potential liabilities were not ones that could reasonably have been foreshadowed and certainly were not of a sufficient basis to be displayed in the financial statements.

Dr SOUTHCOTT—In your review did you find any indemnities or guarantees which had been previously overlooked, and are you confident that your staff are aware of

the need now to record any indemnities and guarantees?

Mr Mitchell—Yes. The Australian National Audit Office regarded us as best practice in relation to that recording mechanism. We have a very rigorous process, as I have already mentioned, and I am extremely confident that we have got the best available mechanism in place in the department to try to capture these sorts of issues as they arise.

Dr SOUTHCOTT—Do you find it difficult to keep a central record of the indemnities and guarantees?

Mr Mitchell—Not at all. We have a very well developed quality assurance program. We review information that has been provided in previous years in assessing current year information for the financial statement process. If there are any omissions or errors in relation to that, we use that as the basis to go back to the program minutes. Also as an essential policy area for the department, we receive a number of queries in relation to these matters as and when they arise. In particular the Geosafe one was a good case in point, where they sought some advice in relation to the sort of information that they would require in establishing a likely value of the liability. We took that midway during the year and we used that information as a process of following it up through to the reporting and the financial statement process.

CHAIR—Could I follow up by asking you about the full review of officers' delegations which, I understand is carried out annually? Do you find reviewing these authorisation arrangements a significant administrative burden? Is it a problem?

Mr Dolan—I wouldn't have said that it was. We find that it is more in the case of delegations than authorisations that there is a serious burden. I take as an example the certifying officer powers under the current Audit Act. Doing minor amendments to those quarterly is a fairly time-consuming process in a department the size of ours, much worse for broader departments. We are hoping in due course to start dealing with those rather than via specific officers to classes of officer, with specific directions within the department as to how powers are to be exercised at various levels. It is part of our regular process of ensuring that we have appropriate control and delegated powers in place, as part of the overheads of the job.

CHAIR—In the audit report the department notes that the program areas maintain contract registers. How comprehensive are the department's contract registers, why do you have them, and what are the benefits?

Mr Dolan—I would have to say that the report is misleading and I don't think it says it. If it says that we currently have a central contract register, we don't. It is something that we are currently investigating. All our contracts are worked through our legal unit and therefore we have a pretty good knowledge of the contracts that are being entered into. But at the moment there is nothing, unless I am mistaken, as formal as a

central contract register.

Mr Mitchell—The contracts that we primarily deal with are for relatively simple procurement of goods and services via running costs. We do not have a larger significant quantity of contracts of the sort of nature that would get an indemnity, guarantee or some form of liability to the Commonwealth that we keep track of. However, in relation to, say, the geoscience issue at Maralinga, certainly the program area maintains a full record of that, and we are confident in the same way that they maintain a record of the actual guarantee information in detail. That sort of information is captured at the program area, but we do not maintain a central register for those issues.

CHAIR—In the audit report at the bottom of page 41 there is a reference to this in the department's response. Do you want to take that on notice and get back to it?

Mr CAUSLEY—The very basis of the audit report is to try to look at the total risk to the taxpayer, and you need to be able to put together, not just from your sphere of influence but all spheres of influence what the total risk is.

Mr Dolan—I see the point of the misunderstanding here, so I do not need to take the matter on notice. I was focusing on the idea of a central register of contracts held in one place in the department. The department operates on a devolved operational basis at the moment under seven operating groups. Within those are a number of different program areas. It is within those devolved areas that various registers are kept. For example, in the Land Resources Division the range of contracts associated with the Landcare programs are held centrally, but there is nothing in the centre of the department as such as a contract register.

CHAIR—How comprehensive are these?

Mr Dolan—I think it would vary. Simple contracts, for example for consultancy services in the standard form for the Commonwealth, generally would be kept with the section of the branch that enters into them. Because they are in a standard form, we know how they are approached and there is no particular need for a centralised monitoring or holding of such contracts. The broad set of contracts that relate to particular programs—and the Landcare program is probably the best example—are held together by the program managers and we know where to go if we require access to that documentation.

CHAIR—Do these contract registers identify guarantees or indemnities?

Mr Dolan—Yes, and there is a requirement that this be done.

CHAIR—So you couldn't quantify the total value of those guarantees and indemnities, or could you?

Mr Dolan—Yes, we have and that is what we have quantified in our financial statements.

CHAIR—It is included there?

Mr Dolan—Yes.

CHAIR—The Department of Finance is undertaking a review of the policy that the Commonwealth carries its own risk. Will this review have implications for the way your department manages its risk associated with guarantees and indemnities?

Mr Dolan—I would expect so. At the moment the Commonwealth or at least individual departments, including our own, have been in the habit of focusing more on risk in terms of exposure to potential fraud than the broader financial risk to the Commonwealth. That has been changing progressively over the past few years. We are getting a greater focus on the overall financial exposure. That is happening in a transitional sort of way. We expect the Department of Finance's review will be of assistance to us in getting an even greater focus on these matters, particularly as we move towards full accrual accounting in the Commonwealth.

Mr CAUSLEY—How does the Commonwealth get involved in guaranteeing the Queensland Fisheries Management Authority?

Mr Dolan—That was, if you like, a one-off. I don't know the full details and if you need them, Mr Causley, I will have to refer the matter to our Fisheries Policy Branch. From my recollection, it was a restructuring of a particular fishery and the loans and guarantee were in terms of changing the amount of effort that was put into the fishery, helping people to make the transition.

Mr CAUSLEY—It might have been the gulf one, was it?

Mr Dolan—I believe so, yes.

CHAIR—You are happy to take further questions on notice?

Mr Dolan—Yes.

CHAIR—Thank you for appearing before the committee.

[10.10 a.m.]

MOORE, Mr Kenneth Lindsay, Assistant Secretary. Resources Policy and Programs, Department of Defence, Russell Offices, Canberra, Australian Capital Territory

LEAK, Miss Dianne Chave, Director of Costings Policy, Department of Defence, Russell Offices, Canberra, Australian Capital Territory

CHAIR—I welcome the representatives of the Department of Defence to today's public hearing. I would remind you that the evidence that you give today is considered to be part of the proceedings of the parliament. Accordingly, I advise you that any attempt to mislead the committee is a very serious matter and could amount to a contempt of the parliament.

Do you wish to make a brief opening statement?

Mr Moore—Yes, Mr Chairman, I would like to take a couple of minutes of the committee's time.

Defence welcomed the audit report when it was received and we also welcome this morning's opportunity to answer specific questions that you may have on the recommendations contained in the report pertaining to the Department of Defence. We would also be pleased this morning to provide you with a progress report on what the department has been able to do so far in terms of specific recommendations, if you so wish.

I would like to state at the outset that the department is a strong supporter of the main thrust of the recommendations. There are several of the recommendations that we will have to look at very carefully in terms of how we would implement them, but that in no way detracts from our basic support for all the recommendations.

This is an area where defence has to do a lot more work and it will take us some time to fully implement all the recommendations throughout the defence organisation. We provided a report to the Minister for Finance in March on progress to date and we will continue to do so.

I might add that our main exposure in terms of guarantees, indemnities, undertaking and letters of comfort is in the area of indemnities, and I will stress throughout the morning that it is the main area that defence gets involved in compared to the other forms of topics covered by the report.

Interestingly, in our annual report last year, bearing in mind we have only been doing accrual reporting in the department for two years, nearly 12 months ago we found about \$185 million worth of contingent liabilities which we put in our financial

statements. That compared to a net balance sheet of \$37 billion. I think it needs to be put into perspective that in the two years since we have been coming to grips with accrual reporting, our main focus has been to identify on-balance sheet items. Our attention now, having we think got them under control, is to turn our attention to these off-balance line items.

I should also add that we have had in place for quite some time a structured approach to the management of risk within defence, particularly major exposure through our major contracts, whether equipment or facilities. All of those major projects are required to have a risk management plan, which would include the management of indemnities or guarantees. Most of the guarantees that we have in those major contracts are our contractors providing us with a guarantee, not the other way around.

It would also be fair to say that we don't have an overall corporate risk management approach to that, and that is something we need to develop. It probably is the way that defence approaches its business. It is a very devolved environment, a resource management environment that we operate in, and we haven't seen a need to have those risk management plans or things like indemnity registers centralised at the portfolio or at my level up until now. Certainly the recommendations of the ANAO report will mean that all that will have to change.

The other thing I would briefly like to mention is the handraulic nature of capturing this sort of information. Not only is it devolved—

CHAIR—What was that word again?

Mr Moore—Handraulic—manually. It must be a defence term! We do not have one integrated management system enabling us to just push a button and capture all this information. We have a number of large corporate systems covering different aspects of our balance sheet. I am sorry to say the liability side is less under control than the asset side, which is our main focus. With about \$70 billion in gross asset terms, you can understand why they are the focus of our attention.

We do have in place now a quarterly return from all our programs on indemnities in particular but, as I said, we are collecting that information manually and it will take us some time before we can automate that process. You will appreciate that with the sheer size of the task for defence, the volume of our contracts and the diverse nature of our operations, it is something that we will not want to jump into.

In conclusion, defence welcomes this audit report. We think we have made a good start in implementing a number of the key recommendations, but I would be the first to admit that we have got a long way to go, particularly in being able to put in place sufficient corporate system support to enable these things to be generated automatically—which, given the size of our operation, is the only way we could manage it.

CHAIR—Thank you. May I take you up on your offer to provide a progress report.

Mr Moore—A copy of the progress report?

CHAIR—You said you were prepared to let us have one.

Mr Moore—Yes.

CHAIR—You talk about the need to do a lot more work. What sort of time frame are you looking at to get in place the recommendations of the Audit Office?

Mr Moore—If I could paint it into the broader picture, whole of government is going accrual budgeting and accounting for the year 1999-2000. We are putting in place a strategic resource management plan that would enable us to do that. I would see what we have to do on this side as fitting in with that broad timetable and that broad approach.

There are a number of things that we can do in the interim in reviewing authorisations for who can approve indemnities, and we have started to do that. But in terms of system support it would probably take until the year 1999-2000 before we would have that in place.

CHAIR—In terms of indemnities, how do you quantify things like blow-outs on contracts? The one in the press recently has related to difficulties with the submarines, which obviously will cost money. How do you account for that?

Mr Moore—It is a complex issue and I am probably not the best to advise you on that because I am not in our acquisitions program. We have a very defined equipment acquisitions strategy before we enter into a contract for any purchase. That identifies where the major risks are and comes up with a risk management plan on how we are going to do that.

When we sign the contract with the prime supplier—and in the case of the submarines it is with the Australian Submarine Corporation—it is up to that prime contractor then to put in place subcontract arrangements for the supply of things like combat data systems, which is what is causing the delay on the submarine project. That is a contractual relationship between the Australian Submarine Corporation and Rockwell, not with the Commonwealth.

We also look at putting in place different types of contracts depending on the level of risk. For example, we identified in the submarine project that the combat data systems software development and integration for the submarine posed one of the major risks in the project. It was clearly articulated in a contractual relationship that we had with the Australian Submarine Corporation and we signed a fixed price contract that where they do

not get it right the first or second time, it really is at the risk of the prime contractor to get it right; it is not the Commonwealth's. And how he does that with his subcontractors is entirely up to him.

To a certain extent what we do is arm's length from being involved on a day to day basis with our major contractors. We let them get on and manage the contract. But we ensure through systems controls that we have put in place that we have visibility of what is going on inside the contract in terms of schedule and cost against a performance baseline. So we know when something is being delayed and why it is being delayed, and we will then ask the contractor to put in place a get-well program, but it is usually at his risk.

Mr CAUSLEY—Are you confident though that those contracts are watertight, because there is a real industry out there at the present time in breaking contracts. If you can break a contract, you can carry on at cost-plus and the price then just escalates. How sophisticated are we in government in drawing up these contracts? Do we have a specialised section within your department or within government to make sure we have these watertight contracts?

Mr Moore—To answer your first question, I don't think you can ever be confident that you have got a watertight contract until you have got your six submarines or eight ANZAC ships and have got what you asked for and paid for. It is a whole industry within the Department of Defence because we are probably one of the largest, if not the largest contract providers in the Commonwealth. Up until 30 June we have had a whole division within the acquisitions organisation, the Industry Involvement and Contracting Division. That has been responsible as our centre of excellence in devising contracts and writing defence policy on the types of contract that should apply to different types of contract.

So far as we know, we are probably up there at the leading edge of having watertight contracts, but we are always finding new ways of contractors trying to wriggle out of their responsibility. It is a hard call sometimes where you do want Australian Defence Force capability at the end of the day, but we have always a very rigorous Australian industry involvement program. The last thing in the world we want to do is send Australian industry broke in the process of trying to meet that ADF capability requirement. So it is often a fine line we walk in how hard we push our contractors. The only way we can do that properly is, as I said before, by properly exposing the risk before we walk into these sorts of contracts, so that the contractor knows and we know exactly what we are letting ourselves in for.

CHAIR—To take you back to Mr Causley's point, the question then is what are the overrun liabilities and I think he used the word 'watertight.' Is there not a more basic problem with the submarine relating to certain components and whether or not it is watertight?

Mr Moore—I am not an expert in the submarine contract.

CHAIR—But I understand that there is a potential material failure that has made all the submarines non-operational.

Mr Moore—I am not aware of that.

Dr SOUTHCOTT—I think it is the hydraulics—they can't go under water.

Mr Moore—That is not true, so far as I am aware.

CHAIR—There was a report in the press a few weeks ago.

Dr SOUTHCOTT—I understand the submarines have got problems with the hydraulics.

Mr Moore—They are fixable.

CHAIR—I am sure they are fixable, but it is a question of liabilities. You say we don't want to push Australian industry too hard and I am sure everyone wants to see Australian industry succeed. But obviously it adds an additional cost or liability to the Commonwealth, and we are trying to work out how you quantify that and report it.

Miss Leak—I would suggest that in the case of the submarines, though I am not entirely familiar with that contract, where there is a product failure defence has quite stringent quality assurance provisions. We also develop our specifications on a functional or performance based specification. Therefore, before equipment is normally accepted, that equipment has to meet that functional specification. In a lot of cases there can also be payments held against that particular performance of that item. Therefore, if it doesn't perform, the contractor is not paid for that. That is a regular part of our contracting procedure.

CHAIR—What has been the cost overrun to date percentage-wise?

Mr Moore—So far as I am aware, there has been no cost overrun. It is a fixed contract; it is not a cost-plus contract. They just don't keep getting money from defence until they get the submarines right. If there is a problem with the hydraulics, it the Australian Submarine Corporation's requirement to fix it. We normally go in for a warranty period with these major pieces of equipment, and again sometimes it is not worth our while doing that because if you ask for a warranty they will build the cost of the warranty into the price they quote you. So we look at all those aspects, and if there is a major risk that we think ought to be covered by a warranty, that is the course of action we take. If we perceive the risk to be low, sometimes we don't go through a warranty.

Dr SOUTHCOTT—Is unexploded ordnance on defence land included in your indemnities?

Mr Moore—I would have to check. Perhaps I could take that on notice. I really don't know. I suspect not.

CHAIR—Coming back to the Audit Office report, what have been the most difficult areas for you to meet in terms of their recommendations?

Mr Moore—In terms of the recommendations that relate to defence, the one we are probably still grappling with is recommendation (8) which requires us to keep a contracts register. The answer at the time suggested that it would be an enormous task for defence to do that, in view of the number of contracts that we let each year. For example, we have 50,000 each year with a value greater than \$2,000. I think the answer defence provided suggested that we might look at doing that for contracts with a value of \$5 million or more.

We do have a centralised database on contracts but it is very broad. It does not go into any sort of detail of what is contained in a contract as to whether there is an indemnity or guarantee in there, let alone much else. We have been talking among ourselves over the past couple of days. If we got recommendation (1) right—in other words, if we kept a complete register of all indemnities, guarantees and undertakings, whether they are in contracts or anywhere else—my thinking at least is that perhaps we could satisfy the recommendation (8) requirement by satisfying recommendation (1).

The last thing I want to do is set up two sets of registers. I mentioned before that we are currently getting a quarterly manual return on all the indemnities that defence has got, and that is starting to work. If we extended that right across the board for all guarantees, indemnities and letters of comfort—bearing in mind that if defence has any letters of comfort they are very few and far between and I haven't found them yet—we think we can satisfy recommendation (8) by doing recommendation (1) properly.

CHAIR—You would be aware of the new Department of Finance circular that has been put around?

Mr Moore—Yes.

CHAIR—Would you care to comment on the guidelines in that new circular?

Mr Moore—My overall reaction to it, having only received it and read it in the past couple of days, is that it provides a useful basis for defence in terms of high level policy. It provides certain definitions, bases of authority, things like that, and we don't really have much quibble with what is in there. We need to turn that into defence policy, if you like. We already have a series of chief executive instructions in the department in

anticipation of the FMA Act. We have had them in place for two years now.

It will be my responsibility to give effect to this finance circular within defence. I think there is probably enough in there for me to be able to do that. But it is too broad with respect to the advice that we will have to give for 14 defence programs. We have got eight up until 30 June. We have just had a major restructuring of defence through the Defence Efficiency Review, and we are moving from eight programs to 14 programs.

To give you an example, the three services—navy, army and air force—are three of our 14 programs. So we need to give them sufficient instructions from portfolio level, which is my level, in how they are to manage and report their contingent liabilities. We intend to do that.

Miss Leak—In going through that DoF circular there were a number of areas and three main ones where we felt there was some information which was still to come which had been highlighted in the original recommendations. Whilst it did address most of those, and we have to get into defence-speak here, we are still awaiting advice from DoF on things such as disclosure and reporting arrangements of indemnities, a bit more information on that; also guarantees and letters of comfort; strategic management of the Commonwealth overall risk; and review of the application of appropriate risk-based systems. We are still awaiting some guidelines on that.

Whilst we in defence can go ahead and develop our own risk strategies, we want to see how that can dovetail into what finance might come up with. We understand that finance consulted with some agencies, but not with defence, in developing the circular to date. In discussions with finance last week we understand that they will be embarking upon further consultation in developing these areas. Whether or not they come to us remains to be seen.

CHAIR—Surely given the size of the contracts and so on that you have been talking about and their quantity, it will be essential that they talk to you, will it not?

Miss Leak—The principles upon which the contracts are based are no different to any Commonwealth contracts, because they would all cover the Department of Administrative Services who are the portfolio advisers to the Commonwealth on procurement policy. Certainly defence may be able to give some specific lights on the volume of contracts we do and any idiosyncrasies related to those.

Dr SOUTHCOTT—In the Audit Report the Department of Defence noted that it was appropriate to keep a central register of indemnities and guarantees. How do you keep a record of your exposure?

Miss Leak—Currently we have within our Canberra-based organisations what we term program coordinators—the current eight programs in defence, soon to be 14. Each

has a position identified which is responsible within their program for collecting this information. It is collected at bases, at units, in divisions around the country, and then the program coordinator calls out just prior to our quarterly returns and says, 'Please forward your listings of registers.' One of their responsibilities is to provide that in a consolidated form to us. We know that they go to individual units and bases because if they are running short of time, they don't coordinate it. We get returns coming in from every little base or unit around the country, so we know that that system is working.

Dr SOUTHCOTT—How readily available is that information?

Miss Leak—It is available from each of those units and bases, if you were to request it, I would imagine reasonably quickly. If you are looking at a consolidated report from, for example, a program coordinator, there would be a time delay in gathering that.

Dr SOUTHCOTT—Are you confident that the agency officers are aware of the need to include things like time limits and financial limits in indemnities?

Miss Leak—Certainly we have written to the program coordinators for dissemination to the areas under the areas that are responsible to them advising of the range of activities that we would like to see on the register, which also obviously includes the amount.

Dr SOUTHCOTT—The Audit Office report also recommended that defence undertake a review of the authorisation arrangements. Have you instituted such a review?

Miss Leak—Yes, we have. That was conducted, and as a result we have reduced the number of positions which are able to give authorisations. With the move to the new program structure with the 14 programs, we will conduct another review.

CHAIR—Unfortunately the committee is running short of time. Given that you have offered to send us a progress report, we will take the course of getting back to you if there are any questions that we will put in writing or possibly deal with at another hearing, if need be. Therefore, we will leave the matter there, and I conclude by thanking you both very much for appearing before us.

Committee adjourned at 10.40 a.m.