

COST TO COMPLETE

5.1 From the Project Office's December 1997 quarterly progress report, the ANAO calculated that 95.7 per cent of the contract sum for the design and construction of the submarines had been spent. At that point, three of the six submarines had been launched and two of these had been commissioned and provisionally accepted into naval service.¹

5.2 The Audit Report stated that the amount of work still to be done was extensive, complex and difficult for Defence to quantify and that significant risks remained in terms of completion schedules and cost to complete. The report advised Defence to urgently review the cost to complete the project.²

5.3 Defence stated that under the terms of the contract the price was fixed, and the contractor was obliged to deliver the contracted scope with no additional Commonwealth funding. Defence added that significant securities in support of the Commonwealth's rights were provided.³ However, the Auditor-General advised the JCPAA that, on the information available, he could not assure the Committee that the project would be completed within the contract price.

5.4 The Committee questioned Defence about whether the submarines would be delivered on budget.

5.5 Defence stated that the best evidence available to them indicated that the project would come in on cost.⁴ Defence added:

We remain confident that the submarines will achieve the capabilities specified in the contract and will be delivered

1 *Audit Report No. 34, 1997-98*, pp. 2, 3.

2 *Audit Report No. 34, 1997-98*, pp. xviii, 25.

3 Defence, Submission No. 1, p. 13.

4 Rear Adm. Peter Purcell, Head, Acquisitions (Maritime and Ground), DAO, *Transcript, 29 April 1998*, p. PA 44.

within the current approved financial provision for the project. The project cost has not increased in real terms but remains within its original budget of \$5.05 billion

*The funds still to be paid to ASC are an important, but not the only, indication of ASC's ability to complete the project. ASC's audited accounts were reviewed during 1997 by two independent groups of chartered accountants, and both accept the director's report that ASC has sufficient financial viability to complete the project.*⁵

5.6 When pressed further by the Committee to attach a degree of certainty to the capability of the *Collins* by the end of 2000, Defence replied that a degree of certainty could not be put on it:

*In [terms of schedules, cost and performance] we acknowledge that there are still risks. We have talked about the cost risk. As far as the contract is concerned, the thing will come in on price because that is what the contract dictates. Whether the contractor has to pick up a whole bunch of costs beyond that or not, we do not really know. What we do know is based on independent accounting advice that [ASC] is viable. Based on our assessments of the work to be done for us, [ASC] will make it within the cost envelope, but there will be no flowback of cost to the Commonwealth.*⁶

5.7 The Committee asked Defence to confirm that there would be no cost overruns.⁷

5.8 Defence responded that although it did not have a right under the contract to access the contractor's costs details, it was satisfied on the basis of external audit of the contractor's estimates to complete and Defence's own estimates to complete that the project could be sustained for three years until 2001, which was after the currently scheduled delivery of the submarines.⁸ Defence added:

5 Mrs Merrilyn McPherson, Acting Deputy Secretary, Acquisition, DAO, *Transcript, 29 April 1998*, p. PA 39.

6 Rear Adm. Peter Purcell, Head, Acquisitions (Maritime and Ground), DAO, *Transcript, 29 April 1998*, p. PA 64.

7 *Transcript, 29 April 1998*, p. PA 56.

8 Mr John Hyman, Commercial Director, Undersea Warfare Systems, Defence, *Transcript, 29 April 1998*, pp. PA 56, 58.

*... within that, there will be some work which the contractor will be required to do which is a rework, so he cannot claim additional progress. We will not be paying him for that work. That is to come from his own resources.*⁹

5.9 The Committee asked Defence whether the situation could arise such that a work package could be completed and payment for it claimed and made, but the package could later be found to require rework.¹⁰

5.10 Defence stated that until work was complete it was not certified by Defence. However Defence agreed that rework may still need to be done even when package scope had been satisfied and a package fully paid out.¹¹

5.11 In response to a question from the Committee, Defence stated that there was no penalty for the contractor if the full value of a work package was claimed and it was then found that the work was incomplete.¹²

5.12 The Committee sought information from Defence on what pressures were being applied to contractors by Defence.¹³

5.13 Defence replied:

*The fundamental pressure that we apply is that we do not take delivery of product until it complies with our requirements; and until we take delivery of product we do not pay. Although we have paid 95 per cent of the project costs at this stage, most of the subsequent payments are now frozen and, particularly where contractors are in a cost overrun situation to deliver the product they are contracted to deliver, they are having to meet those costs.*¹⁴

5.14 Defence stated in March 1999:

9 Mr John Hyman, Commercial Director, Undersea Warfare Systems, Defence, *Transcript, 29 April 1998*, p. PA 56.

10 *Transcript, 29 April 1998*, p. PA 57.

11 Mr John Hyman, Commercial Director, Undersea Warfare Systems, Defence, *Transcript, 29 April 1998*, p. PA 57.

12 Mr John Hyman, Commercial Director, Undersea Warfare Systems, Defence, *Transcript, 29 April 1998*, p. PA 58.

13 *Transcript, 29 April 1998*, p. PA 48.

14 Rear Adm. Peter Purcell, Head, Acquisitions (Maritime and Ground), DAO, *Transcript, 29 April 1998*, p. PA 48.

It may look strange to say that we have paid 95 per cent of whatever the figure happens to be today of the submarine contract, but the contractor has done 95 per cent of the work.

If there is only four per cent of the work remaining, that leads to the question: what if [the contractor] runs into problems and it costs a lot of money to fix? I think there are two answers. Firstly, any good contractor, and certainly this contractor, has a management reserve they keep. They have not allocated all their funds to defined work orders. It is a contingency, if you like, for unexpected events. Secondly, they also have a budget for re-work. As in any large engineering project, a percentage of things will need some degree of re-work, and the contractor has a budget for re-work. All of those things are visible to us, and we believe them to be adequate.¹⁵

5.15 The Committee asked Defence for a comment on ANAO's concern about any additional project costs which might be borne by ASC.¹⁶

5.16 ANAO expressed its concern in the following terms:

Our concern is that we need ASC to remain viable and we need to be assured of that. That is the bottom line here.... We need ASC to maintain those submarines through life.¹⁷

5.17 In response, Defence stated that the figures on the estimated cost to complete were 'commercially sensitive' with respect to ASC, but that Defence had assured itself, in a CSCS review done after the ANAO audit had been completed, that ASC was in a reasonable position to complete the contract.¹⁸

5.18 Later information obtained from the ANAO after it had assessed the Defence review, indicated that the ANAO's original reservations on the financial impact of the remaining project risks remained, although action by Defence to reassess some of the key project risks appeared to be in hand.

15 Mr Garry Jones, Deputy Secretary, Acquisition, Defence, *Transcript*, 5 March 1999, p. PA 90.

16 *Transcript*, 29 April 1998, pp. PA 58-9.

17 Mr Ray McNally, Director, Performance Audit, ANAO, *Transcript*, 29 April 1998, p. PA 59.

18 Mr James Muir, Director, Acquisition Review, DAO, *Transcript*, 29 April 1998, p. PA 59.

5.19 Defence told the Committee in March 1999 that independent audits of ASC had been performed by different commercial auditors and it was Defence's understanding that both audit reports formed the view that ASC had sufficient reserves to complete the project.¹⁹

5.20 ASC told the Committee in March this year that the project was approximately 95 per cent complete and that a slight overrun on the actual production hours would probably result in an overrun of two per cent of the total project.²⁰

*If I achieve that I think my shareholders will be extremely pleased. I am positive and can categorically state that we actually will achieve that.*²¹

Contracted specifications

5.21 The Committee asked Defence whether at the contract cost, ASC would deliver the submarines above or below actual contracted specifications.²²

5.22 Defence acknowledged that there were a number of areas where the submarine did not meet the performance levels sought in the original contract:

We would also have to be honest and admit to you that some of the performance levels we sought were extremely ambitious. We are pushing technology in all sorts of areas....

I believe that the contractor will be able to deliver to us a submarine that we believe satisfies the requirements—that we are contractually satisfied with, if I could put it that way—for both the funds he already has in hand and the remaining funds we plan to pay him for completion of the contract. Why I am hedging a little bit is that there are some areas of the specification at the margin where we will probably agree to a concession, because it is not in either our

19 Mr Garry Jones, Deputy Secretary, Acquisition, Defence, *Transcript, 5 March 1999*, p. PA 109.

20 Mr Hans Ohff, Managing Director, ASC, *Transcript, 22 March 1999*, pp. PA 141, 60.

21 Mr Hans Ohff, Managing Director, ASC, *Transcript, 22 March 1999*, p. PA 160.

22 *Transcript, 5 March 1999*, p. PA 89.

interests or [the contractor's] interests to do that particular thing...

The issue, to jump ahead a little bit, will be in the combat system, exactly what we agree finally can be delivered as part of the contract, and what we then move to in future evolutions of the combat system.²³

5.23 The Committee pressed for further information about how Defence would quantify less than 100 per cent delivery on the contract specifications, and how it would determine where it would compromise and be satisfied with the result.²⁴

5.24 Defence responded that it could not be quantified because it would be looked at on a case-by-case basis:

So far, we have pretty much held the contractor's feet to the fire, so tho speak, in terms of all these specifications. There has been, I guess, a range of minor deviations and waivers as we go through the contract, but they really are minor....

[The contractor] will deliver an acceptable and equivalent product. It may be that in some areas we will agree to concessions. It may be that in other areas we will get extra performance out of the submarine.²⁵

5.25 In the light of its understanding that submarine specifications were being revised and new dimensions added, the Committee sought to clarify Defence's previous assurances that the project would not entail additional expenditure.²⁶

5.26 Defence stated:

In aggregate, none [of the adjustments] are cost adjustments in that we still expect to get the product we are after for the current contract price.²⁷

5.27 However, Defence acknowledged:

23 *Transcript, 5 March 1999, pp. PA 87, 89-90.*

24 *Transcript, 5 March 1999, p. PA 101.*

25 Mr Garry Jones, Deputy Secretary, Acquisition, Defence, *Transcript, 5 March 1999, pp. PA 101, 111.*

26 *Transcript, 5 March 1999, p. PA 110.*

27 Mr Garry Jones, Deputy Secretary, Acquisition, Defence, *Transcript, 5 March 1999, p. PA 111.*

*There will be more money spent on this submarine than is in the contract. That would always have been the case and always will be the case because the configuration will never be static. Throughout its life, we will continue to evolve what our requirements are.*²⁸

Committee comments

5.28 Although Defence has assured the Committee that it expects the project to be completed within the approved total project cost, the Committee notes the Auditor-General's comment that the concept of 'cost' was open to various interpretations. For example, variations to the original specifications may be negotiated as an additional responsibility of the customer and an additional cost. As well as negotiated changes to contracts, there are adjustments for price increases and foreign currency variations.

5.29 Defence has assured the Committee that there will be no ongoing additional costs to the Commonwealth because of the fixed price nature of the submarine project contract. However, the Committee notes that Defence already has plans before the Government for enhancements to the combat system and other areas of the submarine.²⁹

5.30 Defence told the Committee that originally contracted specifications which were not now required or not technologically feasible were being traded for improvements in capability in some areas and for an overall contract amendment package which met Navy's contemporary requirement.³⁰

5.31 The Committee considers that it will be difficult to establish with certainty what additional costs to taxpayers are the result of design and engineering shortfalls and what are legitimate additional costs to make ongoing improvements to the submarines' capability.

28 Mr Garry Jones, Deputy Secretary, Acquisition, Defence, *Transcript*, 5 March 1999, p. PA 110.

29 Cdre Eoin Asker, Director-General, Undersea Warfare Systems, DAO, *Transcript*, 22 March 1999, pp. PA 156, 157.

30 Cdre Eoin Asker, Director-General, Undersea Warfare Systems, DAO, *Transcript*, 22 March 1999, pp. PA 155-7.

5.32 The Committee does not agree with Defence's statement that:

*... [the project] will come in on price because that is what the contract dictates. Whether the contractor has to pick up a whole bunch of costs beyond that or not, we do not really know.... but there will be no flowback of cost to the Commonwealth.*³¹

5.33 Given that the Commonwealth is a major shareholder in ASC (through the Australian Industry Development's Corporation's 48.45 per cent interest in ASC), any costs over and above the contract price which are paid by the contractor would result in costs to the Commonwealth in terms of reduced dividend payments.

5.34 The Committee is concerned, as it was in its report on Defence's management of the Jindalee Operational Radar Network Project³², that Defence's undue reliance on fixed price contracts and apparent lack of concern about wider and ongoing Commonwealth liabilities in the event of cost overruns, continues to have a negative influence on its behaviour towards the contractor and on its project management.

5.35 The long term viability of ASC is also important for the whole-of-life servicing of the submarines. While Defence has told the Committee that ASC's directors continue to affirm the company's ability to meet its obligations and ASC's auditors have certified the directors' report, the Committee considers that there are reasonable grounds for surveillance by Defence of some company policies of the ASC which could jeopardise the company's stability and viability.

5.36 However, the Committee also notes ASC's comments that the Commonwealth, as a major shareholder, was a 'strong driver' in pulling dividends and fees out of the project, and agrees that the Commonwealth should exercise a

31 Rear Adm. Peter Purcell, Head, Acquisitions (Maritime and Ground), DAO, *Transcript, 29 April 1998*, p. PA 64.

32 JCPAA, *Report 357, The Jindalee Operational Radar Network*, March 1998, p. 7.

degree of discipline to ensure that funds are not drawn out of the project unnecessarily.³³

5.37 While ASC has stated categorically that the project will be completed within a two per cent cost overrun,³⁴ the Committee must remain concerned that only three submarines have been provisionally accepted by Navy to date.

5.38 The Committee considers that in view of the remaining level of risk being borne by the Commonwealth, Defence needs to take every opportunity to assure itself of ASC's continuing viability and that sufficient funds remain to ensure the successful completion of the submarine project.

5.39 **Recommendation 4**

The Committee recommends that the Department of Defence apply the utmost diligence to ensuring that the funds the Australian Submarine Corporation has in hand and the remaining funds the Department of Defence has yet to pay under the contract, will be sufficient for the satisfactory completion of the new submarine project.

33 Mr Hans Ohff, Managing Director, ASC, *Transcript, 22 March 1999*, p. PA 142.

34 Mr Hans Ohff, Managing Director, ASC, *Transcript, 22 March 1999*, p. PA 160.