



Australian Government
Department of Defence

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Ms Kris Veenstra
Secretary
Joint Committee on Public Accounts and Audit
Parliament House
CANBERRA ACT 2600

Dear Ms Veenstra

I am pleased to advise you that Defence has completed all responses to questions taken on notice at the Joint Committee on Public Accounts and Audit hearing of 7 December 2006.

Please find enclosed responses to four questions taken on notice at the hearing and 21 written questions. These responses have been approved by the Minister.

If you have any questions, please contact me at the number below.

Yours sincerely

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JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

QUESTIONS TAKEN ON NOTICE FROM 7 DECEMBER 2006 HEARING

QUESTION	TOPIC	COMMITTEE MEMBER	ACTION AREA
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JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

Question 1

ACTION AREA: FFG SPO

Miss Kelly

Hansard, 7 December, p. 6

Costs of legal advice and travel

Please see Table 7.2 of ANAO Audit Report No. 45, 2004-05 and provide the following information:

- a. An update of the table;
- b. The table indicates that \$44m was spent on Travel and Legal Advice in 1997-98. Please provide a breakdown of this figure in relation to the Fast Frigate Upgrade project, including details of when expenses were paid; and
- c. An analysis of whether years that show higher legal expenses coincide with proposed changes to the contract master schedule.

RESPONSE

- a. As this Table was published in an ANAO document, requests for updates should be forwarded to the ANAO.
- b. The actual cumulative costs in 1997-98 as per the Australian National Audit Office report, Table 7.2, totaled \$186,000 comprising \$142,000 for project management and \$44,000 for travel, not \$142m and \$44m. The \$44,000 in the Travel and Legal category was for travel costs only. These costs were attributed to \$25,800 overseas travel and \$18,500 local travel, the latter distributed across the financial year.
- c. Higher legal expenses were incurred in the three financial years 2001/02, 2002/03 and 2003/04. These do coincide with proposed changes to the contract master schedule.

Question 2

ACTION AREA: FFG SPO

Miss Kelly

Hansard 7, December, p. 10

Legal advice

- a. Who provided legal advice to Defence for the FFG Upgrade contract?
- b. Where were funds for legal advice spent?
- c. Who helped design the original contract and provided subsequent legal assistance?
- d. Were the changes all on software?

RESPONSE

- a. and c. Since 1995 the Australian Government Solicitor has provided legal advice on the Project Definition Study contracts with ADI Limited and Transfield Defence Systems. At the time of contract formation, the Australian Government Solicitor was engaged to provide legal advice. Blake Dawson Waldron has provided legal advice in support of contract changes and renegotiations, after initial contract signature.

A number of parties helped draft the original contract after seeking expressions of interest from Industry in 1994, a Request for Proposal (RFP) was released later the same year to prospective contractors. From the final field of four, two contractors were selected in 1995 and contracted in 1996 to conduct Project Definition Studies (PDS). The results of these studies were then analysed and compared, and incorporated into a Major Capability Submission. They formed the basis of the Departmental submission to Government on the scope of Phase 2 of the Project.

The Request for Tender (RFT) for Phase 2 was issued in November 1997 and closed on 9 March 1998. The RFT was based on the then-Defence Acquisition Organisation (DAO) standard contracting template (known as DEFPUR 101 series). It was developed by the Project Office with assistance from the DAO contracts organisation with legal support provided by representatives from the Australian Government Solicitor. ADI was selected as the preferred tenderer for the FFG UP Phase 2 on 13 November 1998. Contract clarifying discussions commenced immediately and formal negotiations began on 22 March 1999. The FFG UP Implementation Phase contract was signed with ADI on 1 June 1999.

- b. Legal advice for the upgrade project has covered a number of contract management areas. Legal Services providers have included both Blake Dawson Waldron and Australian Government Solicitor in respect of these matters. Specific legal advice was sought on:
 - Provision of spares for contractor category five testing;
 - Global Delay settlement (CCP-0086);

- Contract interpretation issues relating to the provision of Government Furnished Material covering the Common Data Link Management System;
- Contract interpretation issues relating the impact of other projects specifically in respect of Electro Optics Tracking System;
- Partial Termination of the Contract (CCP-0255);
- Contract interpretation of Intellectual Property clauses; and
- Acceptance of the Operator Trainers.

d. Changes to the Master Schedule were not solely due to software. Schedule changes have included the Global Delay settlement (CCP-0086) which included hardware and software delays, including Government furnished material. The 2006 partial termination of the contract (CCP-0255) included de-scoping from six to four ship upgrades, revised milestones and schedules, and extant claims for excusable delays such as repairs to hull doubler plates.

Question 3

ACTION AREA: FFG SPO icw HHSD

Dr Jensen

Hansard, 7 December, p. 16, 18

Cost savings

- a. Given that FFG Upgrade contract was a fixed-price contract, how much money has this saved as an offset to the significant delays the project has faced?
- b. What offsets has Defence gained for the ARH project against the slippages?

RESPONSE

- a. The gross price reduction resulting from the partial termination is \$48,181,561. This is greater than the contract budgeted installation cost of \$33,076,549 even after accounting for general overheads and profit (contract base date prices). There were numerous other financial and non financial benefits previously reported to this committee.
- b. The Commonwealth has imposed the following penalties against the contractor in order to compensate for the lack of expected capability:
 - \$286,000 has been claimed and paid for by the contractor for late delivery of engineering deliverables and reviews.
 - \$1,084,907 has been claimed and paid for the late delivery of ARH 6.
 - \$10.7m (dependant on exchange rate) have been accrued for delays to training and will be claimed after the delivery of the ARH simulator.

The contractor has also expended additional resources in an effort to expedite training, including deploying the senior Eurocopter flying instructor to Australia to qualify Australian pilots. At this stage nine Australians have received ARH pilot qualifications, three instructors are now qualified and a further two will complete instructor training in early January.

As an offset to the lower than expected rate of ARH flying effort, the Kiowa rate of flying effort has increased from 7120 hours to 10260 hours for 2006-07; an increase of \$4.037m. The contractor is currently charging the Commonwealth less than the through life support contract rate due to non delivery of aircraft, ground mission equipment, training devices and the lower than contracted flying effort. As a result, ARH through life expenditure for 2006-07 has been reduced by \$10.9m.

Question 4**ACTION AREA: DCEO DMO****Mr Tanner****Hansard, 7 December, p. 24****Risk assessment**

To what extent were senior leaders, both departmental and political, advised on the complexities of the risks involved in making a decision to approve this [FFG Upgrade] project?

RESPONSE

Decision makers, both departmental and political, were appraised of the complexities of this project and the associated risks before making a decision to approve this project. This appraisal process began about four years before the contract was signed on 1 June 1999, following Government approval for proceeding with the Upgrade project implementation. A competitive Project Definition Study (PDS) had commenced in 1995. The Project Definition Study had Defence oversight from the then-Force Structure Policy and Programming Committee, and the Defence Capability Committee.

The solicitation processes were managed by the Defence Acquisition Organisation and a one star (equivalent) Tender Evaluation Board, consisting of representatives of all major stakeholders, reporting to an Augmented Defence Source Selection Board (ADSSB). The ADSSB was specifically briefed by the project on the issues and risks, as these had been identified during Tender evaluation, and formally reported before Source Selection was decided. Due to the pending sale of ADI, the overall Defence Source Selection process and considerations was overseen by the Office of Assets Sales and the Australian Government Solicitor to ensure probity. Government was updated on the status of progress in finalising this project approval.

The Project has been subsequently reviewed both internally within Defence and by Government on several occasions relating to its viability. On each occasion, the decision has remained that the capability to be delivered is required. The project has continued, albeit reduced in scope from six to four ships under the Defence Capability Plan 2003.

Question W1
Lessons learnt

ACTION AREA: DMO

At the 7 December 2006 hearing, DMO undertook to provide an exhibit outlining the 'lessons learnt' during the FFG contract.

- a. Do other SPOs draw up a list of lessons learnt during their acquisition projects?
- b. What would you say are the main lessons learnt during the Air 87 project?
- c. How could DMO have managed the Air 87 project better?

RESPONSE

- a. Yes, lessons learnt databases are compiled for all major activities and projects.
- b. The importance of staffing the project with appropriately qualified personnel; especially in the critical engineering, logistics and training disciplines. This is particularly relevant where the schedule set by Defence is aggressive.
- c. The project has been managed quite well to date. However, successful management of the AIR 87 project in Australian was predicated from the outset on the success on the Franco-German Tiger Project in Europe. European delays were outside the control of the DMO and thus nothing could have been done to improve management in this case. Nevertheless, the DMO did complete the successful management of the ARH production, testing and training in Europe that resulted in the successful achievement of In Service Date on time on budget. The DMO should have then maintained momentum and pressure on the contractor to further develop the capability. While initial efforts were made to progress, only recent major changes in Commonwealth and Contractor management, strategy and culture are now resulting in improved results.

Question W2**ACTION AREA: DMO****Lessons learnt – Future**

Mr Gillis stated that lessons learnt on the FFG project would be studied in future ship building projects (p. 24).

- a. Are 'lessons learnt' consolidated and disseminated to other areas of DMO? If so, who to and how?
- b. Are 'lessons learnt' or case studies being used for training project managers?

RESPONSE

- a. A more formal approach to Lessons Learnt is being developed. It will involve the collection of information and data about projects at various points in the project life cycle. Information sources will vary such as Project Closure Reports, Project Audits, Project Governance meetings, or internal, independent Project Evaluation Reviews. The Lessons Learnt will be held centrally and made available to all staff. An appropriate means of doing this is yet to be defined. It is also anticipated that the Lessons Learnt could be incorporated into building project estimates.
- b. Case studies are becoming more prevalent in the DMO's learning environment. Examples include: Leadership development programs, and the recently developed courses associated with the DMO's Complex Project Management Competency Framework. The use of case studies has been extended to simulation exercises such as that scheduled for February 2007.

Question W3
DMO Staffing

ACTION AREA: DMO

- a. For both the FFG and Air 87 projects, would you please provide a table indicating how many people have occupied the SPO Director position, how long they held this position, and whether they are still with Defence?
- b. For both the FFG and Air 87 projects, would you outline who has responsibility for management of the Projects, including who has been/is responsible for signing at each acceptance stage and who has been/is responsible for signing to make payments?
- c. Is there a high turnover of staff in the FFG and Air 87 SPOs, and, if so, how do you manage the difficulties with retaining corporate and contract knowledge within the SPO?

RESPONSE

- a. **FFG:** The FFG Upgrade dates back to the FFG PUP (Progressive Upgrade) in 1994. The Project Director role has been filled as follows:

	Position	Period	Still with Defence
1	Project Director	1993	Yes, retiring in March 2007.
2	Project Director	1994 – December 1995	Yes
3	Acting Project Director	January – June 1996	No
4	Project Director	8 July 1996 – June 1998	Yes
5	Project Director	April 1998 – January 2002	Yes
6	Project Director	15 January 2002 – August 2003	Yes –Australian Public Service since 1 September 2003
7	Project Director	1 September 2003 – present	Yes

Air 87: This table covers those persons who have had direct Project Authority and held the appointment of Project Director. As such, the table only covers the period post contract signature (December 2001).

	Position Held	Period Held	Still in Defence
1	DGARH – Project Authority	October 2001 – March 2006	No
2	DGAAS – Project Authority	March 2006 – 21 August 2006	Yes
3	Acting DGAAS – Project Authority	21 August 2006 – 4 October 2006	Yes
4	DGAAS – Project Authority	5 October 2006 – present	Yes
5	ARH Project Director	October 2001 – December 2006	No
6	ARH Project Director	January 2007 – present	Yes
7	Acting ARH Project Director	21 August 2006 – 19 January 2007	No

- b. **FFG:** The Project Authority is responsible for managing and administering the Contract on behalf of the Commonwealth, and may delegate functions, or authorise functions to be carried out, on their behalf. The Project Authority for the FFG Upgrade Contract is the FFG Project Director. This includes the responsibility for signing at each acceptance stage and authorising payments within the incumbent's financial delegation. If such payments exceed the individual's financial delegation, it is their responsibility to obtain financial clearance through the appropriate financial framework and appropriate delegate.

Air 87: The Project Authority has overall responsibility for the management of project and normally delegates the day-to-day management to the Project Director. The Project Authority is responsible for accepting contract deliverables through the Supplies Acceptance Certificate. The Project Authority or their delegated representative, in consultation with the key project staff, authorises payments to be made to the contractor.

- c. **FFG:** The turnover of both military and civilian staff in the FFG System Program Office and Upgrade Project is not considered high. In 2006 Australian Public Servant staff separations numbered 12, representing a separation rate of 15 per cent. Military postings and separations totalled 4, representing a turnover rate of 18 per cent.

AIR 87: To date, the turnover in Air 87 Project Office has been lower than normal, notwithstanding the standard military posting cycles. Corporate knowledge is maintained through the lower turnover of Australian Public Service staff and the judicious engagement of Professional Service Providers. Several military staff have been reposted back to Air 87 Project Office into more senior positions.

Question W4

ACTION AREA: DMO

Project payments

- a. With other DMO major projects, what per cent of the contract price is paid to contractors before final acceptance?
- b. What is your view on paying a smaller percentage (than 80 per cent) of the contract price to contractors prior to final acceptance?

RESPONSE

- a. In the case of all major DMO projects, the percentage of the contract price paid to contractors before final acceptance varies significantly. The final percentage is a negotiation issue and will depend on a number of factors including the total number of milestones, the complexity of the project, and the negotiating power of the Commonwealth relative to the contractor.
- b. Paying a smaller percentage of the contract price (i.e. less than 80 per cent) to contractors prior to final acceptance could be possible where the percentage of the total contract work to be performed under the final acceptance milestone, is approximately 20 per cent of the total work. In projects with a large number of milestones conducted over an extended period, this will not normally be the case.

As a general rule, Defence attempts to negotiate an equitable cash-flow for the contractor over the life of the project. However, a mobilisation payment may create a cash-flow positive position for the contractor at the commencement of the project. The size of the final acceptance payment will normally slightly exceed the cost to the contractor to complete the remaining work. This is done to safeguard the Commonwealth against the Contractor not completing the project.

Question W5**ACTION AREA: DMO icw CN****FFG Upgrade Project - Status of Project**

Following the hearing on 12 October 2006, Thales Australia provided a table outlining the FFG Upgrade delivery schedule (see attached).

- a. Do you have confidence in the delivery dates in the table?
- b. At what stage of the acceptance process does the Chief of Navy grant operational release of the FFGs?
- c. What is the high confidence date for Chief of Navy granting operational release of HMAS *Sydney*?

RESPONSE

- a. Yes. A Deed of Settlement and Release was signed on 29 May 2006. ADI undertakings in the settlement of the re-baselined contract point to improved management practices and technical rigour. This has instilled considerably more confidence that the Program will achieve agreed and contracted delivery dates.
- b. Operational Release is the final milestone in the acquisition process. It is achieved when the Chief of Navy, on the recommendation and endorsement of his senior managers (Commander Naval Systems Commander and the Maritime Commander), is satisfied that the equipment is, in all respects, suitable for operational service.

It is expected that the DMO will offer the lead ship, HMAS *Sydney*, to the Navy for Initial Operational Release (IOR) in April 2007. Once IOR is achieved, Navy will conduct a Naval Operational Test and Evaluation process before the ship achieves Operation Release and is cleared to conduct operations without restriction.

It is important to note that HMAS *Sydney* has been delivered with Baseline Build One capability. Full Operational release of the overall FFG capability (Baseline Build Three) is expected to occur in late 2008 shortly after the third ship (HMAS *Darwin*) is provisionally accepted in August 2008.

The FFGs may still be used for routine Navy activities including operations before full Operational Release is given, but under some restrictions, recognising specific ship limitations.

- c. Full Operational Release of HMAS *Sydney* at Baseline Build Three capability is expected in late 2008.

FFG Upgrade Project Delivery Schedule (Submission No. 8, Thales Australia)

FFG UPGRADE PROJECT DELIVERY SCHEDULE, as at 31 October 2006.

Delivered Item	Scheduled Provisional Acceptance	Contractor Delivery to DMO (Handback*)	Revised Provisional Acceptance ** by DMO (CCP0255)	Acceptance***	Final Acceptance****
see Note 1	Date, as at July 2000 see Note 2			By DMO	by DMO see Note 3
Lead FFG Upgrade	17 May 2003	28-Apr-06 (Handback)	15-Dec-06	18-Nov-08	31-Dec-09
2nd FFG Upgrade	16 January 2004	24-Apr-07 (Handback)	12-Oct-07	18-Nov-08	31-Dec-09
3rd FFG Upgrade	11 July 2004	10-Mar-08 (Handback)	26-Aug-08	18-Nov-08	31-Dec-09
4th FFG Upgrade	5 January 2005	11-Dec-08 (Handback)	3-Jun-09	3-Dec-09	31-Dec-09
Team Trainer	4 March 2005	N/A see Note 4	15-Feb-07	31-Dec-09	31-Dec-09
Warfare Systems Support Centre (WSSC)	4 June 2004	N/A see Note 4	18-Nov-08	31-Dec-09	31-Dec-09
Upgraded Software	4 May 2004 (Acceptance)	N/A see Note 4	N/A	18-Nov-08	31-Dec-09
Long Lead Spares	17 May 2003	N/A see Note 4	2-Jun-05	31-Dec-09	31-Dec-09
Operator Training	July 2002	N/A see Note 4	N/A	N/A	N/A

Note 1. This table is based upon the Items listed in the Price & Delivery Schedule - Attachment A, Schedule 1. A number of other Items are now in the current Schedule 1 list. Dates are based upon Attachments A, D & L. as applicable for Handback, Provisional Acceptance and Acceptance.

Note 2. Audit Report No. 45 2004/2005, Management of Selected Defence System Program Offices, p.72, Table 7.1.

Note 3. Original Contract (1 June 1999) the Contract Final Acceptance date was September 2006.
CCP0086 (CA0112 29 April 04) changed Contract Final Acceptance date to October 2008.
CCP0255 (CA0185 2 June 06) changed Contract Final Acceptance date to 31 December 2009. (RAN Caveat of no more than 2 FFGs in Upgrade at any one time)

Note 4. N/A as Handback only applies to FFG ships.

* Handback means the return of an FFG to the Commonwealth, including for the operational requirements of the RAN (which use shall not constitute Provisional Acceptance or Acceptance under the Contract)

** Provisional Acceptance means the certification by the Project Authority that the Contractor has fulfilled its contractual obligations in respect of any upgraded FFGs or upgraded facilities listed on a Supplies Release Note (SG8), subject to any omissions or defects listed on that SG8, and that those upgraded FFGs or upgraded facilities conform with the requirements of the Contract, and Provisional Acceptance is subject to Acceptance and Final Acceptance. Provisional Acceptance is signified by the Project Authority signing an SG8.

*** Acceptance means the certification by the Project Authority that the Contractor has fulfilled its contractual obligations in respect of any item or items of the Supplies or for an upgraded FFG or upgraded facility or Upgraded Software listed on an SG1, subject to any omissions or defects listed on that SG1, and that those Supplies or upgraded FFG or upgraded facility or Upgraded Software conform with the requirements of the Contract, and Acceptance is subject to Final Acceptance.

**** Final Acceptance means the certification by the Project Authority that the Contractor has fulfilled all its contractual obligations in respect of achieving Acceptance of the Upgraded FFGs, Acceptance of the Upgraded Facilities, Acceptance of the Upgraded Software and Acceptance of those Supplies required to be supplied prior to Final Acceptance, subject to any omissions or defects listed on an SG1, and that the FFGs, facilities, Upgraded Software and all of the Supplies conform with the requirements of the Contract. Final Acceptance is signified by the Project Authority signing an SG1.

Question W6**ACTION AREA: DMO icw CN****FFG Upgrade Project - Status of Project**

At the 12 October 2006 hearing ADI advised the Committee that contractual delivery and provisional acceptance on 15 December 2006 of HMAS *Sydney* was to be done on the basis of a paper-based assessment (p. 15).

- a. Is this the usual model adopted by the DMO?
- b. What impact has the schedule slippage had on the final life of service for each ship?
- c. What are the estimated annual operating costs to the Navy since 2003-04 of the slippage in the delivery of HMAS *Sydney* and rescheduling of other ships?

RESPONSE

- a. HMAS *Sydney* followed the DMO's usual model for contractual provisional acceptance of Maritime elements. This involved the verification and validation of objective quality evidence to support acceptance of the supplies. This is achieved through a system engineering approach to testing and verification of that testing undertaken.
- b. None. The final life of service for each ship will largely be governed by the introduction into service of the Advanced Air Warfare Destroyer (AWD) capability to be delivered under SEA 4000. The Planned Withdrawal Date for each FFG is linked to the introduction into service of the AWD to ensure Navy retains a viable Area Air Defence capability for deployed maritime forces. This is driven largely by a necessity to re-deploy the FFG workforce into the AWD capability. Therefore, any slippage in the Upgrade program will largely not influence the final life of each ship.
- c. In January 2006 the Minister for Defence agreed to a portfolio supplementation in 2006/07 of up to \$21m for continued sustainment costs to the end of 2007 for the operation of HMAS *Adelaide*. This was as a result of the deferral of the Planned Withdrawal Date of HMAS *Adelaide* from service from November 2006 to not later than the end of 2007. A contributing factor to this decision was to mitigate the impact to Navy's Area Air Defence capability resulting from delays in the FFG Upgrade project. This represents an increase of approximately 1.4 per cent on the original budget of \$1483.697m.

Question W7

ACTION AREA: DMO icw CN

FFG Upgrade Project - Status of Project

At the 7 December 2006 hearing, Rear Admiral Ruting stated:

“...because the FFGs are effectively being progressively upgraded and delivered to the different baselines, we will have had significant operational use of, for example, HMAS *Sydney* for quite some time. So, even though final contract acceptance may not occur until 2009-10, we will actually have had the earlier ships out operating with quite substantial increases in capability and we will be allowing their operational use with that additional capability over much of the time.” (pp. 26-7)

- a. Will the Navy have use of the ships prior to final acceptance?
- b. If so, when and with what capability?

RESPONSE

- a. Yes. The Navy currently has use of the Lead ship for the upgrade, HMAS *Sydney*, and the contracted delivery schedule has been amended to follow the same model for the three remaining FFGs for upgrade.
- b. The Navy is expected to have access to and use of HMAS *Melbourne* in the July 2007 timeframe, with Provisional Acceptance occurring in October 2007. HMAS *Darwin* will be handed back to Navy in March 2008 with Provisional Acceptance in August 2008. HMAS *Newcastle* is expected to be handed back to Navy in December 2008 with Provisional Acceptance in June 2009. Final Acceptance under the Contract is 31 December 2009 when all upgraded FFGs will have upgraded software and the full contracted capability.

The contract allows for progressive delivery of the capability. All production and hardware installation is completed prior to the FFGs being Provisionally Accepted. The software is progressively updated against three baselines and will be installed, fielded and tested in the upgraded FFGs when finalised and ready.

Question W8

ACTION AREA: DMO icw CN

FFG Upgrade Project - Status of Project

Please outline the progress on the upgrade of the four FFGs:

- a. What dry dock work has been conducted?
- b. What has been the result of testing at sea of the HMAS *Sydney*? On 31 May 2006 at Senate Estimates (p. 120 of transcript) Rear Admiral Ruting spoke of three critical areas (underwater systems, electronic support measures system, combat management system) where HMAS *Sydney* had contracted deficiencies. What is the status of those deficiencies?
- c. Have any further problems been discovered?
- d. What is your future program of sea trialling of problems?
- e. What are the total project costs as amended over the life of the project?

RESPONSE

- a. HMA Ships *Sydney* (26 March 2004) and *Melbourne* (12 July 2006) have completed the docking component of their upgrade and the concurrent scheduled maintenance for the retained legacy systems. HMAS *Darwin* commenced the docking phase on 3 January 2007 and is expected to complete the docking element in early June 2007. HMAS *Newcastle* is scheduled to enter upgrade for the docking element of the upgrade in early October 2007.

HMAS *Sydney* has also required three additional dockings since March 2004. The first, 18 April – 31 August 2005, was to complete repairs as a result of cracking found in the hull doubler plates and to remove operational restrictions imposed through the hull certification process. This is unrelated to the FFG Upgrade.

The second docking, an unscheduled docking 23 – 26 January 2006, was to complete an investigation relating to the fitted Mine Obstacle and Avoidance Sonar (MOAS). The third docking, 4 October – 14 December 2006, was to conduct the docking component of the scheduled maintenance availability (DSRA8) in accordance with the maintenance usage upkeep cycle.

Dry dock work conducted in the concurrent Upgrade and Maintenance Selected Restricted Availability (refit) consisted of scheduled maintenance, repair of defects and the removal and installing of upgrade equipment. For example, the following scope of work is typically completed:

- Underwater valves;
- Replacement of Auxiliary Propulsion Units;
- Hull preservation to meet Environmental Protection Authority requirements;
- External hull surveys;

- Preservation of the internal hull and tanks;
 - Shaft and propeller related maintenance and repairs;
 - Maintenance on Fin Stabilisers;
 - Hull preservation (patch repair) including renewal of anodes;
 - Repairs to areas of internal corroded hull plating and tanks including cropping and renewing of hull plating;
 - Preservation of tanks, voids and bilges;
 - Repairs to MOAS and Electro Magnetic Log; and
 - Replacement of Sonar Dome.
- b. Sea trials have demonstrated improved performance overall in the upgraded FFG. Identified deficiencies with the Underwater Warfare Systems, Electronic Support System and Australian Distributed Architecture Combat System Software are now captured in the Report of the Materiel and Equipment Performance State (TI338). Work is to continue by ADI Ltd to rectify shortfalls before Acceptance (scheduled to occur by 18 November 2008).
- c. No.
- d. HMAS *Sydney* will commence a detailed series of Navy sea trials in April 2007.
- e. The June 1999 prime contract with ADI was \$899.576m (February 1998 basis). Current estimated price is now \$1170.764m (December 2006 prices), including refit (SRA) work completed under the Upgrade contract but funded from the FFG Operational Sustainment Budget.

Project Approval

Original (December 1997)	\$1266.000m
Price Variation	\$ 170.514m
Exchange	\$ 197.222m
Real Increase	-\$ 153.439m
Current (December 2006)	\$1480.297m

The real decrease resulted mainly from the transfer of funds for missile procurement to the Evolved SeaSparrow project.

Question W9
Capability

ACTION AREA: CN icw DMO

- a. Would you give a brief outline of current naval capability and how this has been affected by the upgrade delays, including the absence of at least one operational FFG (HMAS *Sydney*) and the decommissioning of two more, over the last couple of years?
- b. What are the knock-on effects and costs of the FFG Upgrade Project slippage eg. on fleet activity, naval training, crew and personnel leave management?

RESPONSE

- a. Regrettably, Defence cannot provide a detailed summary of Naval capability as this would require the disclosure of classified information

The effects of the upgrade delays on capability have been mitigated to an extent by the extension of HMAS *Adelaide* to the end of 2007 (originally planned to decommission in September 2006). Furthermore, some operational tasking that might have been undertaken by FFGs has been transferred to other classes of ship. This has remained manageable, causing minimal overall impact on Navy capability and the Surface Combatant Force Element Group (SCFEG) has met all Directed Level of Capability (DLOC) requirements. Moreover, the commissioning of the new ANZAC Frigates *Toowoomba* and *Perth* in late 2005 and 2006 respectively has assisted Navy to manage capability requirements.

- b. These aspects have attracted very careful management attention by Navy and, consequently, the FFG Upgrade has not had a significant impact on fleet activity, training and personnel leave management. This close management will continue throughout the Upgrade process.

Question W10

ACTION AREA: DMO

Contract Management

- a. The Audit Report states (p. 69) that while the FFGSPO may raise problems through Problem Identification Reports and Non-Conformance Reports, the Contractor is under no obligation to accept or take action on the issues raised.
 - i. How many times has FFGSPO issued a Problem Identification Report or a Non-Conformance Report to ADI?
 - ii. What has been their reaction?
 - iii. What does DMO do if ADI does not take action on the problems raised – is rejection of the completed work the only remedy?

RESPONSE

- a.
 - i. The Commonwealth has raised 43 Problem Identification Reports and 34 Non-Conformance Reports.
 - ii. The Contractor has logged all Commonwealth Problem Identification Reports and Non-Conformance Reports into the Problem Report management system. These reports are routinely screened and reviewed as part of the management of the activities of the project.
 - iii. The Provisional Acceptance and Acceptance of the Supplies under the Contract are underpinned by the Problem Report count (which includes Problem Identification Reports and Non-Conformance Reports). The Commonwealth has the ability to reject non-conforming Supplies where the Problem Report count exceeds the threshold in the contract.

The status of Problem Identification Reports and Non-Conformance Reports was, and is, a consideration in decisions affecting handback, delivery, Initial Operational Release and Final Acceptance. These are documented in Handback Status Documents and the Report of Material and Equipment Performance State. In each case, a strategic overview is taken of the aggregate effect of these on the integrity of the capability being offered. The DMO consults with Navy on the impacts of these issues, and this is in turn a consideration in the DMO's dealings with the Contractor.

Question W11**ACTION AREA: DMO****Contract Management**

The Audit Report (p. 83) states that SPO personnel lacked confidence in the validity of the ADI's Contract Master Schedule (CMS). By August 2002, ADI had produced six revised CMSs.

- a. Does the DMO have high confidence in the current version of the Contract Master Schedule?
- b. How many revised Contract Master Schedules have been produced by ADI since the start of the project?

RESPONSE

- a. There is an increased level of confidence in the ability of ADI to delivery this program within the revised schedule. The schedule was agreed with the signing of the Deed of Settlement and Release on 29 May 2006. The detailed ADI replan and resultant Contract Master Schedule are still being finalised.
- b. Seven.

Question W12

ACTION AREA: DMO

Risk Management

- a. The Audit Report (p. 89) states that damages payable by ADI in the event of poor performance were capped at \$30m. This amount was reduced to nil following ADI's parent company becoming guarantor for the proper performance of the contract.
- i. What is DMO's policy on including liquidated damages clauses in contracts?
 - ii. Would you like to comment on how your contracts compare with Qantas which had received \$104m in liquidated damages due to schedule delays for its A380 aircraft?
- b. What level of risk and non-performance by the contractor should be accepted by DMO (the Australian Government)?

RESPONSE

- a.
- i. The DMO's policy on including liquidated damages clauses in contracts is represented in the Australian Defence Contracting contract templates. These include mandatory liquidated damages clauses in all major capital equipment contracts. The amounts are negotiated on a contract by contract basis and must represent a genuine pre estimate of the loss likely to be suffered by the DMO on the occurrence of particular events, such as schedule delay.

When a liquidated damages event occurs, damages in the form agreed between the parties become due. Under present policy, liquidated damages may be claimed in the form of cash or compensatory work/supplies, or a combination of both, depending on what has been negotiated.
 - ii. Defence is not in a position to comment on the commercial arrangements that have been negotiated between Qantas and Airbus.
- b. In DMO contracts, consistent with Commonwealth policy, risks should be borne by the party best placed to manage them (Commonwealth Procurement Guidelines, paragraph 6.10). This may be the Commonwealth, the Contractor, or both.

The level of risk accepted by DMO will vary from contract to contract, depending on the nature of the particular procurement. Factors such as the amount of developmental work, Information Technology integration, and customisation will affect the risk profile, from the perspective of both the DMO and the contractor. Where more risk is accepted by the DMO, a lower price will normally be negotiated, noting also the level of competition in the relevant market.

In some cases, the acceptance of high levels of risk by DMO in order to deliver capability requirements is unavoidable. DMO considers that a successful project is one that delivers a fit-for-purpose capability, as approved by Government, within the approved budget and schedule.

The Australian Defence Contracting contract templates contain a number of mechanisms to distribute risk between the parties, with some room to negotiate on a case by case basis. Appropriate remedies, such as liquidated damages and termination, are also included to allow contractor non-performance to be dealt with appropriately.

Question W13

ACTION AREA: DMO

Project Payments

The FFG Upgrade Project contract price is fixed at \$1138.29m (December 2004 prices), comprising 71 milestone payments and monthly progress payments based on the Earned Value Management System (EVMS). By February 2005, payments to the contractor had totalled \$919.13m or 80 per cent of the contract price (Audit Report, p. 79).

- a. What has the Australian Government received to date, for its \$919m?
- b. Does this amount include around \$700m of equipment for six FFG Upgrades, as originally contracted?
- c. What will the spare two sets of equipment now be used for? Where are they being stored?
- d. Is the equipment received by Defence for FFG Upgrades properly recorded in the SDSS System?
- e. Why would DMO pay EVM payments of \$88.9m between December 1999 to June 2000, prior to the approval of ADI's EVMS Performance Measurement Baseline (Audit Report, p. 19)?
- f. Was a milestone payable on the 'Handback' of HMAS *Sydney* by ADI on 28 April 2006? If so, how much was paid?
- g. When are future milestone payments due, and for what amounts? Are milestone payments attached to provisional acceptance, acceptance and final acceptance?

RESPONSE

- a. Substantial progress has been made towards production completion. This includes significant progress on engineering, and software development and production; procurement of six ship sets of completion of shore facilities; installation and Provisional Acceptance of the Lead ship HMAS *Sydney*; substantial progress to installation on first follow on ship HMAS *Melbourne*; commencement of installation on third follow on ship HMAS *Darwin*; and long lead spares availability, amongst other items.
- b. Yes.
- c. It is likely that the equipment for ship sets five and six will be used for a variety of applications. These include provision of in-country training for both operators and maintainers in Sydney and Perth, in some cases replacing training previously provided in the USA; risk reduction activities for the FFG SM-1 replacement project (one set of radar and onboard training system equipment retained in the USA for system development and test activities); additional integration and support assets at the FFG Upgrade Warfare Systems Support

Centre (WSSC) in Garden Island; and major support spares for the four upgraded FFGs

The equipment delivered by the Prime Contractor, ADI Ltd, to the Commonwealth is stored at the Defence National Storage and Distribution Centre, Moorebank, New South Wales. The exceptions are one Mk 41 Vertical Launch system now installed in the ANZAC Support facility at HMAS *Stirling* and one shipset each of Continuous Wave Illuminator (radar) and onboard training system equipment retained in the USA for system development and test activities.

The equipment either retained by ADI for test and development purposes or not yet due for delivery remains under ADI control and storage responsibility. This is stored at Garden Island, Sydney. Data link equipment purchased under foreign military sales arrangements by the Commonwealth for ships 5 and 6 is being used by ADI in the software development process to mitigate the risk of Link 16 delivery and is stored at the Thales Australia software development site in Western Australia.

- d. The first two stages of project delivery for ship sets five and six have occurred, with equipment accepted and set to work, or transferred to defence stores through the standard defence supply system. This five stage approach has been delivered to meet the Navy requirements and the prime contractor's risk mitigation requirements for the remaining Upgrade project. The staged approach enabled the FFGSPO to verify all the equipment status, content, finalise codification and conduct acceptance procedures in an orderly manner.

A delivery was part of the negotiated agreement in the Deed of Settlement and Release signed on 29 May 2006. The first two stages have occurred with equipment accepted and set to work or transferred to the Defence stores through the Standard Defence Supply System (SDSS). The third stage is on schedule to occur in March 2007.

- e. ADI submitted invoices to the Commonwealth as claims for payment for work progressed or completed primarily through its subcontractors. The claims were supported by a breakdown of the work packages progressed and the status of project progress in an earned value management format. The Commonwealth validated and verified the work was either progressed or completed as applicable in the claim. On this basis the Commonwealth authorised payments to ensure subcontracts were established and work commenced and progressed in a timely manner while matters relating to formally approving the ADI Earned Value Management system were progressed.
- f. Within the fixed price contract, a milestone payment of \$3,000,000 (contract base date dollars) was allocated to achievement of Hand-back. This was achieved and paid in accordance with the contract.

- g. There are numerous milestones remaining in the contract, including Provisional Acceptance and Acceptance of Ships and Combat System software, and Final Acceptance on contract completion. The milestone schedule was reviewed and, as part of the Deed of Settlement and Release on 29 May 2006, changes were made to provide greater focus on product achievement at milestones.

Question W14**ACTION AREA: DMO****Air 87 Project - Armed Reconnaissance Helicopters (ARH) - Status of Air 87 Project**

- a. Can you please provide an update of the status of the retrofits to the ARHs?
- b. When do you expect to have the aircraft flying at full capability according to the contract?
- c. The original Budget (signed December 2001) consisted of two parts, \$1.1 billion Acquisition Contract and \$410.9m Through-life Support Contract. The total project budget (as at May 2006) was \$1.96 billion (see Audit Report No.36, p.13). What is the current total project budget?
- d. What is the cost to the Australian Government in lost training time for the retrofits?

RESPONSE

- a. ARH 1 is currently scheduled to complete its retrofit program in March 2007, which will see it being delivered in a similar configuration to that of ARH 6. ARH 2 will then enter its retrofit program at the Australian Aerospace Production facility in April 2007. ARH 3 through 5 will be undertaken at intervals of four months following completion of the ARH 2 retrofit program.
- b. Australian Aerospace has advised the Project Office that ARH 12 will be the first aircraft presented to the Commonwealth that meets the contractually required configuration with acceptance currently planned to be completed by March 2008. The ARH engineering certification activities required to realise a fully compliant ARH capability will take longer and are currently planned to be completed by March 2009.
- c. The total budget of \$1.955 billion in Australian National Audit Office report June 2005 was adjusted to \$1.987 billion in January 2007, (+\$0.893m cumulative exchange rate variation and +\$30.59m cumulative price index variation). There is no real cost increase.
- d. The cost of retrofit is being borne by the contractor Australian Aerospace. Training will be conducted on other aircraft as they all cycle through the retrofit process; liquidated damages will be imposed for the late delivery of aircraft.

Question W15
Contract changes

ACTION AREA: DMO

- a. How many contract change proposals have been approved? What have these been for?
- b. How many contract change proposals are in progress?
- c. At the hearing on 19 October 2006, there was discussion around Australian Aerospace's proposed cost increases in the through life support budget of up to 84 per cent of total cost.
 - i. How are these negotiations going from DMO's point of view?
 - ii. Is DMO considering providing Australian Aerospace with these cost increases?
 - iii. If an increase is granted to Australian Aerospace, would the losing bidders for Project Air87 have a claim to reimbursement of costs incurred in tendering?

RESPONSE

- a. **FFG Upgrade Project.** At 7 December 2006 there were a total of 207 Contract Change Proposals (CCP) approved for the FFG Upgrade project. The Approved Contract changes fall within the following categories:

Contract Change Category	Number of Contract Changes	Percentage of Contract value
Contract Options – taken up	16	87.23
Official Orders – Concurrent refit work	50	33.86
Delay – Acts of Prevention	4	22.08
Scope Change	20	2.19
Administrative alignment of the Contract and Specifications	113	0.22
Additional training	3	0.16
6 to 4 ships Contract Price reduction	1	-45.74
Total:	207	100

Air 87 Project. Total CCPs raised: 28 x Through Life Support (TLS) Contract with three (11 per cent) initiated by the Commonwealth; and 137 x Acquisition Contract with 48 (35 per cent) initiated by the Commonwealth.

CCPs Approved: 8 x TLS Contract ; and 73 x Acquisition Contract.

- 68 per cent of these were administration / no cost CCPs,
- The remainder either had some cost implication or scope change with either cost or no cost implication;

- 18 per cent of the approved CCPs had cost implications. The top seven CCPs equated to a total of approx \$14m which is 1.21 per cent of the contract budget.

Note: Although the original requirement for the contract change may have been initiated by the Commonwealth, all CCPs were raised by Australian Aerospace for Commonwealth approval in accordance with the Acquisition Contract. The numbers include multiple issues of CCPs as some CCPs were initially rejected and were required to be re-submitted by Australian Aerospace.

- b. The FFG Upgrade project currently has seven contract change proposals as work in progress. The Air87 project currently has 14 contract change proposals as work in progress. Nine of the AIR 87 CCPs relate to the Acquisition Contract, of these:

- Four relate to the Instrumented ARH Enhancements;
- One concerns to update to spares list;
- One is in regard to Aircrew Training Device specification alignment; and
- Three relate to Groundcrew Training Device specification alignment, enhancements and milestone split.

Five of the AIR 87 CCPs relate to the Through Life Support (TLS) Contract, specifically concerning:

- correction of errors in financial rates tables;
- spares list update;
- proposals for new rates;
- process change for return of Fly Away Kits; and
- update to list of sub-contractors.

c.

- i. The original Contract Change Proposal (CCP 008) for the 84 per cent increase was rejected as there was insufficient justification that all of the additional cost proposed was for work outside the existing contracted Statement of Work. Of specific concern were additional costs for third party support contracts without a measurable or definable work outcome.

Australian Aerospace was requested to break down the proposed changes into discrete packages that could be better assessed on their own merits against the existing contracted Statement of Work, and in order of priority to support the ARH System as it transitions into service. To date, Australian Aerospace has submitted two such CCPs (T012 and T015), both of which have been rejected by the Commonwealth.

- ii. The DMO is prepared consider cost increases that meet the specific criteria. The Project Office has advised Australian Aerospace that the only CCPs to be reviewed and negotiated for approval are:
- administrative and corrective changes;
 - extant Statement of Work and sub-contract related and corrective changes; and
 - organisational staffing level changes

Where the changes are:

- Commonwealth instigated;
- justified by Australian Aerospace;
- endorsed by the customer to whom the service is to be provided;
- approved by the appropriate delegate; and
- represent value for money.

The remainder of the contract activities and support required to ensure the delivery of services should be delivered under the existing contract in accordance with the original price until the ARH System and the Contract environment have reached a level of maturity defined or represented as:

- ARH Certification has meeting contracted specification;
- ARH Training System reaches the mature stage and training devices have been accepted;
- ARH reliability and availability being sufficient to ensure the contracted Rate of Effort;
- all TLS requirements being in place to support the ARH System.

Third party support contracts will not be approved by the Commonwealth until a level of system maturity is reached as described above. Current expectation is that this will not be before Year 5 of the TLS Contract.

However, should critical tasks or out of scope work be required, these will be managed by exception under the Indefinite Quantity (IQ) terms of the TLS Contract and individually quoted and approved by the Commonwealth.

- iii. No, it is not DMO policy to reimburse the costs of tendering.

Question W16
Contract changes

ACTION AREA: DMO

Page 25 of the Australian National Audit Office (ANAO) Audit Report states:

“The development, and delivery of training equipment and courseware has been delayed against the originally contracted delivery dates by up to 15 months. The DMO accepted a contract change proposal that subsequently amended the agreed acceptance date for the aircrew training device simulators to July 2005. Defence advised the ANAO that the simulators are now not expected to be accepted before July 2006.”

- a. Were the training simulators accepted before July 2006?
- b. Has a claim been made for liquidated damages for the late delivery of the training-related milestones?

RESPONSE

- a. No. The training simulators are currently planned to be accepted before September 2007.
- b. A claim has not been made, but the Project Office has advised Australian Aerospace that the Commonwealth intends to claim the maximum Liquidated Damages payable under the Acquisition Contract for late delivery of the training Supplies.

Question W17

ACTION AREA: DMO

Tender Process

- a. The acquisition of the ARH was to be based on an “off-the-shelf” procurement, representing low risk to Defence. The Defence Capability Manual 2005 defines off-the-shelf as:

“a product that will be available for purchase, and will have been delivered to another Military or Government body or Commercial enterprise in a similar form to that being purchased at the time of the approval being sought.”

Please comment on whether the ARH contract began life as an off-the-shelf purchase as was originally intended?

- b. Brigadier Patch stated at Senate Budget Estimates hearing on 31 May 2006:

“AIR 87 was chosen as one of the vanguard projects for the Defence Materiel organisation reform agenda” (p. 147)

Also, the DMO advised the Australian National Audit Office (ANAO) that:

“Project Air 87 was the lead project to considerable reform, where tender evaluation for a very complex project was done in six weeks (compared to the traditional six months, compressed three months and the finally permitted six weeks) and the negotiation in two weeks when simpler projects have taken about six months.” (Audit Report, Footnote 18, p. 18).

- i. Are the tender evaluation methods piloted in the Air 87 Project now the norm within Defence?
 - ii. Is six weeks long enough to conduct a proper evaluation?
 - iii. Given the criticisms of the management of the Air 87 Project by the ANAO, what ‘lessons learnt’ have been incorporated into ‘best practice’ tender evaluation within Defence?
- c. The Committee received a submission from Mr Joe Moharich, whose company represented Bell Helicopter Textron, one of the losing bidders for Project Air 87. Mr Moharich states in his submission:

“The total lack of transparency in the acquisition processes is the key issue. It is a widely held belief that when the DMO negotiates with a "Preferred Tenderer" the final, "negotiated" contract bears very little resemblance to what was specified in the "Request for Tender". The DMO steadfastly refuses to divulge the contents of a contract, citing "Commercial Confidentiality". Debriefs to losing bidders are invariably meaningless, with the DMO stating only that the contract was awarded on the basis of DMO's assessment that the chosen contractor offered the "Best Value for Money"”

Would you like to respond to Mr Moharich's statement?

- d. At the Committee's 19 October 2006 hearing in an answer to Dr Jensen regarding the original tender including the building of commercial helicopters, Mr Saporito responded:

"That is happening. Our commitment was to establish an assembly line in Brisbane for the Tiger armed reconnaissance helicopter ARH and also to establish an assembly line for the so-called EC 120, which is a single-engine civil helicopter. This has happened. We have already assembled 11 aircraft in Brisbane."

- i. Was it a requirement in the Request for Tender issued by DMO to set up a commercial production line in Australia?
- ii. Exactly what was the requirement in the final contract for a commercial production programme?

RESPONSE

a.

In May 2000, acting VCDF, Air Vice Marshall Nicholson provided the DMO with the following direction, "I believe that the Request for Tender must make it clear to industry that we wish them to bid a standard configuration helicopter, which will be in at least Low Rate Initial Production at the time of contracting as their primary offering". The Tiger was in Low Rate Initial Production with France and Germany at the time of contract signature.

The ARH remains as close as practicable to an off-the-shelf procurement as originally planned.

b.

- i. Each Project is assessed on its complexity and risk, and the evaluation methodology is tailored accordingly. However, a reduction in tender assessment timing is part of the DMO Procurement Reform, principally intended to reduce tendering costs to industry.

Air 87 was not a designated pilot reform project. Nevertheless some of the lessons learnt from the associated tender evaluation process have been embodied in the current Defence Procurement Policy Manual.

- ii. Yes, in the case of Air 87. One of the principal objectives of the current Defence Procurement policy, procedures and templates is to minimise the cost of tendering to both Industry and the Commonwealth. The length of time for tender evaluations varies on a case by case basis depending on things such as the number of tender responses and the complexity of the evaluation criteria. In the case of Air 87, six weeks was considered reasonable because the tendering and evaluation strategy implemented for Project Air 87 included:

- interaction between the Commonwealth and tenderers during the tender development phase;
- scope for tenderers to propose their preferred contract, based on the draft contract provided by the Commonwealth in the Project Air 87 Request For Tender;
- interaction between the Commonwealth and tenderers during tender evaluation so that optimal configurations could be developed from the proposals submitted;
- early exclusion of tendered solutions that did not meet the Commonwealth's requirements, or were not affordable;
- exclusion of tendered solutions progressively during the evaluation when they were identified as being uncompetitive;
- the intention to conduct simultaneous negotiations with the most competitive tenderers, with the objective of developing acceptable (and possibly dissimilar) contracts (including the Conditions of Contract, Statement of Work and Specifications);
- the intention to request price confirmation of offers for the financial elements of the contracts developed during simultaneous negotiations; and
- streamlined reporting arrangements and devolution of authority in line with the project management methodology adopted by the DMO.

iii. Despite having not yet reached the Project Closure stage, some of the lessons learned from the Air 87 tender evaluation process have been incorporated into the current Defence Procurement Policy Manual.

The ARH Project has fallen behind schedule predominantly due the vital disciplines of Training and Integrated Logistics Support (ILS). Accordingly, both the common contractor for MRH90 Australian Aerospace and the Commonwealth MRH Project Team have bolstered their training and ILS organisations with quality personnel, some of whom had previously been involved in the ARH program. This enabled the retention of corporate knowledge across the two programs. Senior Engineering and Project Managers from the ARH Project have also now returned to work on the MRH90 Program. This is true on both the contractor and Commonwealth sides of the contract, and includes the following staff: Design Acceptance Authority, Engineering Manager, Project Manager and Senior Software Engineer. Additionally, the head of the ARH Project team who delivered the ARH at In Service Date has now returned as the Director General of all Army Aviation Projects.

c. Bell Helicopter Textron was formally debriefed on its Air 87 tender on 18 February 2002. Mr Moharich did not attend that debrief.

d.

i. Yes.

ii. Australian Industry commitment required by the Air 87 contract is valued at \$640m.

The commitment required Eurocopter to establish an EC120 assembly line in Australia with a production rate foreseen between 20 to 40 helicopters per year. Australian Aerospace was contracted to carry out all operations up to the delivery of the EC120 helicopters including customisation and certification. They were also required to:

- adapt the EC120 avionics and radio communication systems to specific requirements;
- provide the technical assistance that EC120 customers expect; and
- provide Support Services such as blade repairs, dynamic component overhaul generating long term additional incomes.

As part of the assembly line work, Eurocopter International Pacific will:

- assemble EC120 helicopters from kits delivered by Eurocopter;
- tailor the EC120 avionics and radio-communications systems to customer requirements;
- perform the ground tests of the EC120 helicopter avionics and systems;
- perform the flight tests;
- obtain the airworthiness certificate; and
- deliver the EC120 helicopters to the customers.

In addition, Australian Aerospace has a mandate to sell and support the EC120 helicopters to Japan and other countries as appropriate.

For support, Australian Aerospace will extend its centre of excellence in blade repairs and in Squirrel mechanical repair and overhaul to provide support to EC120 customers.

Question W18

ACTION AREA: DMO

Acceptance of ARH

- a. The Australian National Audit Office (ANAO) was informed that it is the DMO's practice to accept deliverables with contractual shortfalls, and operational limitations, on a risk managed basis, to progress Defence specific training, and testing activities, to deliver the required operational capability (Audit Report, p. 20).

Also, Lieutenant General Leahy stated at the Senate Budget Estimates on 31 May 2006 (pp. 143-44):

“We are very prepared to admit that the aircraft is not yet at the standard required in the contract. It was a conscious decision to accept the aircraft with known and quantified shortfalls against the mature requirement, so that Australian based training could commence and Australian-specific flight testing could be conducted.”

- i. Why is Defence paying up-front for specifications in contracts that they are not getting? What is the risk to the Australian Government in making up-front payments rather than arrears payments?
 - ii. Instead of accepting “contractual shortfalls”, could Defence contracts specify a certain level of capability that will be accepted for training and testing, and a higher level that will be accepted for final delivery?
 - iii. Please describe DMO's standard “risk managed basis” for accepting deliverables with contractual shortfalls and operational limitations. e.g. is the risk management process documented, are officers appropriately trained in making a risk-based decision on how to accept a deliverable with contractual shortfalls?
 - iv. Does Defence have a mandated policy on what is “not acceptable”? e.g. what level of deficiencies is Defence prepared to accept?
- b. The DMO accepted the first of the 18 Australian assembled aircraft on 1 June 2005 ARH 5, on the basis of the draft acceptance procedure. Acceptance followed a Production Acceptance Test and Evaluation Report compiled by the Defence Aircraft Research and Development Unit (ARDU) Test Team on 30 May 2005 that recommended the DMO should not accept the aircraft in its delivered state (Audit Report, p. 21). DMO subsequently accepted ARH 6.
- i. Did the ARDU recommend acceptance of this aircraft?
 - ii. Should an independent body (such as CASA or a commercial enterprise) conduct airworthiness safety tests and evaluations for Defence acquisitions? Is it a conflict of interest for ARDU to conduct safety tests and evaluations?

- c. The DMO advised the ANAO that there is no specific DMO or Defence requirement that mandates liaison between the DMO and the Capability Manager [e.g. the Army Operational Airworthiness Authority] prior to the DMO accepting goods and services from Contractors on behalf of Defence (Audit Report, footnote 27).

Does Defence/DMO consider it to be good practice to accept a contracted deliverable without the input of the capability manager?

- d. Page 18 of the Audit Report states:

“There was no valid Operational Airworthiness Authority delegation that allowed the DMO’s Project Director to accept ARH 5.”

- i. Did the DMO Project Director have a valid Operational Airworthiness Authority delegation to accept ARH 6?
- ii. What processes have Defence/DMO put in place to ensure the DMO Project Director has a valid Operational Airworthiness Authority delegation for accepting future aircraft?

RESPONSE

- a.
- i. DMO only pays for products delivered and or work completed in accordance with contractual requirements. In the case of Air 87 acceptance of ARH below the final contract specification was known, planned and contractually agreed. Indeed, final contract configuration cannot be achieved without an incremental acceptance process. The reasons for this include: United States licensing limitations; delays in the Franco-German program; and unique Australian test and certification requirements, for example communication and missile sub-systems.

There is no risk to the Australian Government. Defence pays for the products it receives. However, Defence must remain cognisant that the Commonwealth has entered a business relationship with the contractor, who needs cash flow to remain viable. In the case of ARH, the configuration and standard of delivered products has been, and will continue to be, agreed in advance of delivery. Payment for that product and the withholding until it is delivered to the contractually compliant standard is also well known, planned and contractually agreed by both parties.
 - ii. Defence does not intentionally enter contracts that contain shortfalls. However, in the case of Air 87, the intent was to achieve an incremental maturing of the capability during aircraft production to final configuration status.
 - iii. There are no specific risk management guidelines covering situations for accepting contractual shortfalls. However the DMO Project Risk

Management Manual (PRMM) is specific in its requirements for conducting risk assessments at various points throughout the contract and transition phases of a project. The PRMM addresses situations where new risks and significant events arise during the life of a project. The need to accept contractual shortfalls would certainly be considered a "significant event".

DMO Project Managers are trained to make various decisions throughout the life of a project, using skills and processes available in the standard "project manager's toolbox". Risk management (including risk assessment) is one of those tools. DMO's risk management process is documented in the PRMM, which is available to all project staff. In 2006, the DMO commenced a project to improve its application of risk management at the project level. This will progress throughout 2007.

- iv. No. Deficiencies that might be deemed "not acceptable" vary on a project by project basis and are subject to risk assessment, consolation and formal acceptance processes.
- b.
 - i. Yes. The Production Acceptance Test and Evaluation report, from an ARDU-approved Flight Test Plan, recommended the ARH 6 was satisfactory for acceptance. The aircraft was subsequently accepted by the Commonwealth in May 2006.
 - ii. No. CASA is the civilian airworthiness authority with the Chief of the Air Force holding responsibility for military airworthiness. ARDU was established to provide independent airworthiness assessments of ADF aircraft. There is no conflict of interest as ARDU is an independent body to the DMO.
- c. No, this recommendation has been agreed by DMO and implemented. In the case of Air 87 and AIR 9000, the Director General Army Aviation Systems will on all occasions now actively seek Capability Manager involvement, especially in the area of acceptance of aircraft and introduction into service.
- d.
 - i. No, the delegation was vested in the Project Authority (Director General Army Aviation Systems) and was duly applied for the acceptance of ARH 6.
 - ii. A delegation has been granted to the Project Authority (Director General Army Aviation Systems) in order to prevent recurrence of this situation.

Question W19

ACTION AREA: DMO

Defence/ANAO disagreement

- a. Lieutenant General Leahy at the Department of Foreign Affairs Defence and Trade Senate Budget Estimates stated (p. 143):

“It is the view of Defence that both the aircraft and the status of the project are far better than was described and it is our intention to provide you with some information to back this judgment.”

And on page 158 of the Senate Budget Estimates:

“Senator MARK BISHOP—Why don’t Australian National Audit Office buy that argument you have just put?

Brigadier Patch—I have no idea. I spent 11 months trying to convince them of it”.

- i. Given that there has been considerable disagreement between DMO and the Australian National Audit Office (ANAO) in the past regarding this audit, have you been able to come to agreement, or is the management of the Air 87 Project still an area of contention?
- ii. What are the implications of this disagreement for future audits?
- iii. Do Defence/DMO and ANAO have fundamentally opposing views on the appropriate way to manage a major capital acquisition project?

RESPONSE

- a.
- i. Agreement has been reached; DMO has accepted the five recommendations from the Air 87 ANAO Audit report and is implementing compliance measures. The management of Project Air 87 is not an area of contention, but as it is one of the top 10 DMO projects (based on value) it will continue to attract a high level of corporate oversight.
 - ii. There should be no implications for future audits arising from this audit.
 - iii. No.

Question W20

ACTION AREA: DMO

Milestone payments and Earned Value Management Payments

- a. There are 126 milestone payments (which account for 60 per cent of the total value), and monthly progress payments under the Earned Value Management System (which account for 40 per cent of the total value). (Audit Report, p. 13 and Senate Budget Estimates, p. 164)
 - i. How many milestone payments have been made?
 - ii. Have all of the milestone payments been made in full?
 - iii. How many earned value management payments have occurred and at what cost?
- b. The DMO withheld 50 per cent of the Type Certification milestone payment associated with acceptance of the first two aircraft, until the conditions for the recommendation of an award of an Australian Military Type Certificate had been met. The DMO advised the Australian National Audit Office that payment of the remaining 50 per cent of this milestone was authorised for payment in October 2005, even though some of the design issues had not been finalised. (Audit Report p. 20 and footnote 22).
 - i. Was the final 50 per cent milestone payment made for ARH 1 and ARH 2? If so, were the "design issues" finalised before payment?
 - ii. Are these the design issues being rectified through the retrofit of ARH 1 (which was due to be completed in November 2006 according to p. 17 of Audit report)?

RESPONSE

- a.
 - i. 81.
 - ii. No. All payments are assessed on the basis of the contractor's achievement against the payment criteria for each milestone. The Commonwealth has on 11 occasions withheld anywhere from 20 to 50 per cent of the milestone value pending achievement of payment criteria. At this time, partial payments apply to five such milestones.
 - iii. Earned Value Management (EVM) payments commenced in December 2003 following completion of Integrated Baseline Reviews, with EVM payments being made on a monthly basis thereafter. The cumulative total of EVM payments made to 31 December 2006 is \$397m.

b.

- i. Yes, once the method to achieve the final contractual configuration was agreed. Fundamentally, the “design issues” were finalised before payment, which involved the implementation of an ARH Type Acceptance and Retrofit program at no additional cost to the Commonwealth.
- ii. Some of the design issues will be rectified through the current retrofit of ARH 1. However, further retrofit will be required for ARH 1 to achieve final contractual configuration at no additional cost to the Commonwealth.

Question W21
Intellectual Property

ACTION AREA: DMO

a. Page 20 of the Audit Report states:

“The Australian National Audit Office considers that the Defence Material Organisation would benefit from an Intellectual Property review, with the aim of ensuring Contractor, and sub-contractor Intellectual Property is being maintained in a state that can be used as and when required to support the capability.”

- i. Has an intellectual property review occurred?
- b. At the Department of Foreign Affairs Defence and Trade Senate Budget Estimates on 31 May 2006 (p.163) Defence suggested that if other nations fit the Hellfire capability, Defence has the opportunity to earn royalties, which may be sufficient to completely cover costs for the development of the Hellfire capability.
- i. Do you know if any other nations intend to fit the Hellfire capability?
 - ii. Is Defence/DMO actively encouraging other nations to fit the Hellfire capability?

RESPONSE

- a.
 - i. Yes. A Preliminary Intellectual Property (IP) audit for Project Air 87 was conducted on 13 and 14 December 2006. The audit team examined the Australian Aerospace IP management and control system to ensure that:
 - management mechanisms (staff and procedures) were in place to govern the IP controls process;
 - IP identification was an ongoing activity;
 - record keeping with respect to IP schedules, registers and reports was accurate; and
 - protection of IP rights (for future application if necessary) was captured consistent manner.
- b.
 - i. France and Spain have expressed interest in Hellfire and have entered discussion with Eurocopter regarding this matter.
 - ii. Yes.