



MINISTER FOR DEFENCE
THE HON DR BRENDAN NELSON MP

01 NOV 2006

Senator David Johnston
Chair
Senate Standing Committee on Foreign Affairs,
Defence and Trade
Parliament House
CANBERRA ACT 2600

David
Dear Senator Johnston

I write to provide information sought by the Senate Standing Committee on Foreign Affairs, Defence and Trade following Defence's appearance before the Committee at the 31 May – 1 June 2006 Budget Hearings. The Committee sought advice on the private financing costs of the new Defence Headquarters Joint Operations Command facility to be constructed approximately 11 kilometres south west of Bungendore, New South Wales.

On 30 May 2006, Senator the Hon Sandy Macdonald announced that Praeco Propriety Limited (Praeco), a consortium of Leighton Contractors Propriety Limited and ABN AMRO Australian Limited, had been selected as the preferred tenderer to deliver the buildings, infrastructure and services components of the Headquarters Joint Operations Command Project under private financing arrangements for a 30-year term on the basis of better value for money to the Commonwealth than traditional procurement. The contract with Praeco was finalised on 30 June 2006 and the consortium reached financial close with its financiers on 28 July 2006.

The Government approved the Headquarters Joint Operations Command Project in March 2004 at an estimated capital cost of \$301 million (2003-04). The revised estimated capital cost, updated to take account of inflation, is \$339.2 million (2006-07 Budget prices, out-turned).

The \$339.2 million comprises \$250.8 million for the buildings and infrastructure and \$88.4 million for the Command, Control, Communications, Computing and Intelligence (C4I) Systems, land acquisition and other project elements. Under the private financing arrangements, the \$250.8 million was returned to the Government budget in the context of the 2006-07 Budget and in return Defence was supplemented

by a lease stream of \$19.1 million (2006-07 Budget prices, out-turned) per annum commencing in 2008-09 as a contribution to the Annual Service Payment to Praeco. The remaining funds required to meet the Annual Service Payments are programmed in Defence's Financial Estimates and future budget allocations.

The construction of the buildings and site infrastructure is expected to be completed in July 2008, to be followed immediately by the installation, testing and commissioning of the C4I Systems.

While the contract with Praeco is for 30 years from 30 June 2006, the first Annual Service Payment to Praeco does not commence until July 2008, after the construction of the facility. The first Annual Service Payment is a part year payment of \$33.44 million (2006-07 Budget prices, out-turned, GST exclusive) to take account of the reduced monthly payments required for July to November 2008 when only a small number of Praeco staff are required to support the installation, testing and commissioning of the C4I Systems. The first full year Annual Service Payment of \$39.99 million (2006-07 Budget prices, out-turned, GST exclusive) commences in 2009-10.

While the Annual Service Payment is largely fixed in value, there is an element for the provision of the services that is indexed. The Annual Service Payment is recalculated on an annual basis on the anniversary of the contract and adjusted for inflation using indices provided by the Department of Finance and Administration.

The Annual Service Payment is paid as a Monthly Service Payment in arrears. The monthly payments may be adjusted by abatements for poor performance of service during the previous month. The abatement regime is described in the Project Deed, and the amount of any abatement would be approved by the Defence contract administrator.

At financial close on 28 July 2006, the financial modelling determined that the whole-of-life net present value for the provision by Praeco of the buildings, infrastructure and services over the 30 year term to be \$572.2 million (2006-07 Budget prices, out-turned).

As with other Defence projects, there is a capital element which is subject to Government approval and there is a whole-of-life support element funded through the operating budget.

Recent media comment has confused the difference between the capital cost of the project and the whole-of-life cost over the 30 year period. The figure of \$1.2 billion mentioned in the media represents the nominal whole-of-life cost over the 30 year term, and any suggestion that this represents a blow out in the cost of the project is wrong. As well as capital, the amount includes the cost of the services, maintenance, mid-life refurbishment and the forecast impact of inflation over the life of the contract.

Another way of expressing the whole-of-life cost is in net present value terms. On this basis, the net present value of the project is \$572.2 million, with a capital element of \$234.57 million, which is less than the \$250.8 million capital element of the approved project cost.

The evaluation of the financial aspects of the tenders was conducted against a Project Cost Benchmark, also referred to as a Public Sector Comparator. The Project Cost Benchmark was developed by consultants engaged by Defence and in consultation with the Department of Finance and Administration. The methodology used in the development of the Project Cost Benchmark was in accordance with the Commonwealth Policy Principles for the Use of Private Financing.

The Project Cost Benchmark was based on the construction and whole-of-life cost of the facility, excluding the C4I Systems costs, for 30 years on a net present value basis. The model represented the direct procurement option and incorporated an estimate of the cost of the risks that would be retained by Defence under separate direct procurement contracts for design, construction, maintenance and garrison support services.

The base Project Cost Benchmark was provided to the tenderers as part of the tender information with the intention that it would provide them with advice on the scope and affordability of the project and aid the development of their tenders. To ensure a competitive tender process, the Project Cost Benchmark provided to the tenderers did not contain the net present value of the transferable risks; it was up to the tenderers to assess the risks and ensure adequate allowances were made in their tendered price for the possibility of the risks eventuating.

The tender evaluation compared the net present cost of the tenders to the risk adjusted Project Cost Benchmark on a Whole of Government basis, and the value for money assessment contained both quantitative and qualitative elements.

The significant quantitative elements were the assessment of the tenders against the Project Cost Benchmark and the costs that could be identified against any 'risk pushback' to the Commonwealth evident in each tenderer's marked-up project documents. The costs associated with delays to the project schedule were also identified and costed. Qualitative elements included the level of acceptance of the proposed risk allocation by each tenderer and the functionality or 'liveability' of their proposed design solution.

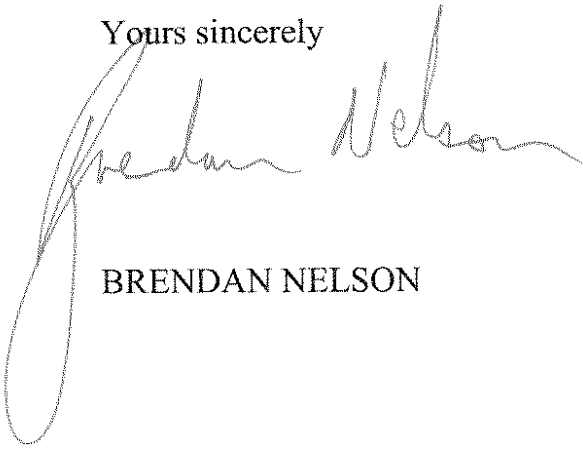
On the basis of the overall value for money evaluation, Praeco's tender was assessed as providing better value for money to the Commonwealth over the 30 year contract term than could be gained under traditional procurement of separate contracts for design, construction, maintenance and garrison support services. Also, the net present value of

the facilities component of Praeco's tendered price was less than the net present value of that element of the project approved by Government.

I understand that the Committee may wish to seek further information about the tender evaluation process and outcomes. Given the commercially sensitive nature of some the information, I would be prepared to offer the Committee a private briefing by the Project Office on these matters.

I have copied this letter to the Minister for Finance and Administration, Senator the Hon Nick Minchin.

Yours sincerely

A handwritten signature in cursive script that reads "Brendan Nelson". The signature is written in dark ink and is positioned to the left of the printed name.

BRENDAN NELSON