CHAPTER TEN

COST SAVINGS

Introduction

10.1 The overriding objectives of the information technology (IT) outsourcing Initiative announced in the 1997–98 Budget were to achieve long-term improvements in the structuring and sourcing of IT systems from private contractors across government agencies, and to realise significant cost savings. Other benefits that were expected under the Initiative were reduced tender costs to government and industry, efficiency in contract management, and an opportunity to enhance Australia's information technology and telecommunications (IT&T) industry, particularly in regional areas.[1]

10.2 While the Government's stated aims were varied, the core objectives as set out in each request for tender (RFT) show that contracts would be awarded on the basis of an evaluation of anticipated cost savings, and in-scope industry development (ID) commitments.[2] Indeed, the earlier RFTs make an unequivocal statement that achievement of substantial cost savings is a precondition to the award of a contract.[3] The cost savings argument was repeated by the Government on many occasions during the Initiative, including in the period following the Humphry Review where, according to the Office of Asset Sales and IT Outsourcing (OASITO), the Government retained the Initiative's core objectives: achieving value for money and ID outcomes.[4]

10.3 The main problem for the Committee in considering the matter of cost savings was the scarcity of reliable information on cost savings and the difficulty in reconciling the various methods used to estimate the level of savings that could be expected from IT outsourcing. This has been a major obstacle to gaining an understanding of the process of estimating costs and savings and makes it difficult for the Committee to make an unqualified assessment of the Initiative. Nonetheless, evidence presented to the Committee raised doubts about the predicted cost savings that point to short comings in the methodology used to estimate these savings.

10.4 This chapter focuses on a number of weaknesses with the financial methodology used by OASITO to calculate estimated cash savings for each of the tenders—referred to as the financial evaluation methodology. While the Committee

---

1 Office of Asset Sales and IT Outsourcing (OASITO), submission no. 4.

2 For dates of requests for tender (RFTs), see Table 1, Chapter 4, p. 37.

3 See Health Group RFT, 90.1 and 90.2 released on 30 November 1998.

4 OASITO, submission no. 4.

relies heavily upon the Australian National Audit Office (ANAO) report on the Initiative, evidence provided to it by various agencies builds on its findings.

10.5 From the beginning of the Initiative, the lack of transparency associated with how cost savings were originally estimated created uncertainty. The bald announcement in 1997 about an estimated $1 billion saving to the Commonwealth from IT outsourcing did little to give the Initiative credibility, especially since no comprehensive data was brought forward to substantiate the claim.

10.6 In July 1998, the Minister for Finance and Administration described how this figure was reached:

> A scoping study of the potential savings that could accrue to the Commonwealth through the consolidation and potential outsourcing of its many IBM and compatible data centres was conducted in 1996. This study demonstrated that a very strong business case for outsourcing existed, and led to the decision by Cabinet reflected in the 1997/98 Budget to undertake extensive market testing of Commonwealth IT.
>
> Across budget funded agencies, potential savings in the order of $1 billion are realisable, over the term of multiple, seven year contracts. These savings were not estimated in isolation—Agencies had input into the methodology for costing the evaluation, and they took into account initial market testing. The savings to the Budget are robust and they are conservative.[5]

10.7 In May 1997, in anticipation of such savings, the Government announced reductions in the forward estimates of agencies.[6] According to OASITO, the assumptions regarding savings that underpin the reductions to the forward estimates of Budget-funded agencies were the subject of intensive consultations across sixty-three agencies in the 1996–97 scoping study that was undertaken by the Department of Finance and Administration (DOFA) and the Office of Government Information Technology (OGIT).[7] According to Dr Boxall, Secretary of DOFA, the scoping-study was 'the most sophisticated and well researched across the board savings exercise that has been undertaken'.[8]

10.8 However accurate this statement, subsequent events indicate that the scoping study did not provide a solid basis on which to build the Initiative. The main objective sought by reducing forward estimates of agency budgets for the Initiative was to

---

5 Minister for Finance and Administration, the Hon. John Fahey, MP, An address to the Information Technology Outsourcing Seminar, Freehill, Hollingdale and Page, 29 July 1998.

6 See para 3.5.

7 OASITO, Submission no. 4. The Department of Finance and Administration (DOFA) in its submission states 'The budget savings were determined on the basis of a comprehensive scoping study of IT infrastructure costs and relevant business and IT requirements undertaken by OGIT, in conjunction with DOFA, covering 66 departments and budget-funded agencies. Detailed questionaires were sent to 24 agencies covering approximately 69% of total running costs'. DOFA submission no. 3.

8 Committee, *Hansard*, 7 February 2001, p. 105.

encourage agencies to 'generate savings'. In practice this meant that if 'agencies generate more savings than the adjustments to their forward estimates they can keep the difference. Where they generate less savings, they absorb the difference'.[9]

10.9 ANAO advised that it was difficult to draw parallels between the savings identified in the individual tender processes and the reductions made to agency forward estimates, because the financial evaluations:

(a) **did not quantify** the extent to which agencies may have improved internal efficiency in preparation of the tender process; and

(b) **included** services not considered in the calculation of the agency budget reductions applied in respect of the IT initiative (i.e., voice telecommunications and applications development and maintenance services).[10]

10.10 The Committee wishes to draw attention to sharp criticisms of the policy of reducing agency budgets in anticipation of savings. The Community and Public Sector Union (CPSU), for example, argued that the 'stripping of agency budgets…in our view contributed to job losses'. In its view, budget cuts 'should be…returned to agency budgets that have never enjoyed the anticipated returns claimed for the initiative'.[11] The Combined Unions at the Australian Nuclear Science and Technology Organisation (ANSTO) also argued strongly that the savings identified by DOFA were 'largely illusory' and that members of staff involved in the process had indicated that the 'identified figures appeared to have little in relation to the information supplied by them to the Department of Finance'.[12] Dr Pauline Gallagher, Assistant Secretary, the Commonwealth Scientific and Industrial Research Organisation (CSIRO) Staff Association, expressed the view that the deductions from agency appropriations was partly responsible for the damage inflicted on science research within that organisation.[13]

10.11 The Committee agrees that budget cuts in anticipation of savings should not be used to encourage agencies to outsource their IT.

---

9 OASITO, submission no. 4.

10 Australian National Audit Office (ANAO), *Implementation of Whole-of-Government Information Technology Infrastructure Consolidation and Outsourcing Initiative,* Audit Report No. 9 2000–2001, p. 21.

11 Community and Public Sector Union (CPSU), submission no. 10.

12 Australian Nuclear Science and Technology Organisation (ANSTO) Combined Union, submission no. 12.

13 Committee, *Hansard*, 16 March 2001, p. 355.

Cost savings as an objective in IT outsourcing

10.12 In implementing the Initiative, the Government was committed to ensure adequate savings.[14] As noted earlier, IT outsourcing was expected to save the Commonwealth some $1 billion over seven years.[15]

10.13 The Committee points out that the cost savings argument for IT outsourcing was considered in some detail in the report that was prepared for the Minister for Finance by the Information Technology Review Group (ITRG) in March 1995.[16] The Group considered a variety of submissions that expressed views on cost savings ranging from extremely optimistic to very cautious. While the views on cost savings were then quite varied, the report concluded that many organisations outsource IT for reasons other than cost savings. These reasons include: 'achieving greater reliability, disaster recovery at a lower cost than they can achieve in-house, and to get better service externally for Local and Wide Area Networks than can be obtained internally'.[17] One of the report's main points suggests that IT outsourcing is often considered a viable option on grounds other than cost savings.

10.14 The Committee received several submissions that addressed, to varying degrees, the issue of cost savings. A critical perspective of the optimistic forecasts of large savings was provided by Dr Leslie Willcocks.[18] He made a number of important observations on the Australian Government's experience with IT outsourcing. On the issue of cost savings, for example, he argues:

> The initial and regular announcements of substantial cost savings through outsourcing government IT continually surprised me in the Australian context, because our own findings rarely supported such outcomes. One common finding in both private and public sectors, across especially the large deals, is that they are pervaded by voodoo economics.[19]

10.15 At a public hearing, Dr Willcox referred to his 'practice survey' of Australian IT outsourcing published in March 2001. He described some of the findings of the survey as they relate to Australian IT outsourcing and savings:

---

14 See for example, Minister for Finance and Administration, the Hon. John Fahey, MP, an address to the Information Technology Outsourcing Seminar, Freehill, Hollingdale and Page, 29 July 1998.

15 See Mr John Fahey, Question without notice, House of Representatives, *Hansard*, 28 May 1997, p. 4265.

16 Report of Minister for Finance's Information Technology Review Group, *Clients First: the Challenge for Government of Information Technology*, Commonwealth of Australia, 1 March 1995.

17 ibid., p. 59.

18 Dr Willcocks, Andersen Professor of Information Management and E-Business, University of Warwick, and author of six books and over 35 refereed papers on IT outsourcing since 1991, describes himself as 'an independent academic researcher on a global basis'. His most recent major work on IT outsourcing (co-authored with Dr Mary C. Lacity) is *Global Information Technology Outsourcing: in Search of Business Advantage*, John Wiley & Sons Ltd, Chishester, 2001.

19 Dr L. Willcocks, submission no. 28.

> Looking at your Australian outsourcing results, I think only 35 per cent of the organisations we surveyed in Australia—and a considerable number were public sector—get moderate savings, seven per cent get substantial savings and the rest have no change or actually higher costs as a result of outsourcing.[20]

10.16 Mr Glenn, Principal for Strategic Development, the Sausage Group, expressed the view that cost savings is only one potential value proposition and should not be the criterion driving IT outsourcing, a view that is shared by Computer Sciences Corporation (CSC) Managing Director, Mr Bell.[21] According to Mr Glenn, the Initiative's focus on cost savings 'skewed the evaluation criteria. It preclude[d] the establishment of a service delivery model that is structured to achieve successful business outcomes for both parties'.[22] He told the Committee that the outsourcing Initiative's focus on cost savings 'fails to recognise the…value propositions that come from outsourcing'. In particular, in building contractual relationships the issue that has not been recognised 'is the principle that risk best lies where it can be resolved'.[23]

10.17 The Committee also notes that some of the difficulties it has experienced in determining actual savings from IT outsourcing applies to Commonwealth outsourcing programs in general. In a recent review of arguments for and against outsourcing, it was noted that much of the literature on outsourcing supports the view that outsourcing is likely to result in some cost savings. However, the same literature review 'identifies a number of factors that may impact on the existence or extent of such savings'. Citing recent studies by Professors Quiggin and Mulgan of the Australian National University and Dr Hodge of Monash University, the review's author, Ms R. Verspanndonk noted:

> There is no single answer to the question of whether outsourcing saves money. This is because of differences between situations, the range of factors that need to be considered, and measurement issues…[24]

Ms Verspanndonk draws out an important conclusion in relation to cost savings and outsourcing, that 'cost savings…are not a foregone conclusion…efficiency gains are variable and need to be determined on a case by case basis'.[25]

Substantiating claims of savings

10.18 The Committee believes that the issue of cost savings is not as clear-cut as some of the more optimistic, and at times misleading, pronouncements suggested by

---

20 Committee, *Hansard*, 17 May 2001, p. 508.

21 The Sausage Group, submission no. 7; Mr Bell, CSC, Committee, *Hansard*, 6 August 2001, p. 654.

22 Sausage Software Limited, submission no. 7.

23 Committee, *Hansard*, 16 March 2001, p. 351.

24 Ms R. Verspanndonk, *Outsourcing—For and Against*, Current Issues Brief No. 18 2001–01, Department of the Parliamentary Library, Canberra, p. 5.

25 ibid., p. 6.

the Government, the Humphry Review, OASITO, and DOFA. It recalls Minister Fahey's announcement in November 1997 that the Government estimated that IT outsourcing 'will save taxpayers approximately $1 billion over seven years'.[26] The Minister asserted 'post-Humphry' in January 2001, that savings to Australian taxpayers 'in the order of hundreds of millions of dollars' have been delivered from the five contracts that have been awarded covering 23 agencies with a contract value of $1.2 billion.[27] Yet the evidence to support these optimistic savings targets has not been provided.

10.19 Even the Humphry Review, while its terms of reference did not include cost savings, made several unsubstantiated and general observations. For example, the Review states: 'There is broad agreement that, in the aggregate, the Initiative had delivered significant savings, however there is a divergence of opinion as to the precise quantum'.[28] The Review's interpretation of 'significant savings' is not explored or supported by any figures. More contentious is the Review's use of comments made by the Auditor-General on the savings issue, and the ANAO's report on IT outsourcing. According to the Review: 'While the Auditor General has commented upon the savings, he has been very clear in his report, and in Senate Estimates hearings, that regardless of the methodology for calculation of savings, there are significant savings'.[29] See paragraph 10.52 for further detail on the Auditor-General's statement.

10.20 Mr Humphry advised the Committee that during the course of his discussions with agencies about their IT outsourcing experience, he wanted to see 'whether they could assess to what extent they had made savings'. He summarised the outcome of these discussions in the following terms:

> Many of them felt that it would be impossible to calculate the savings because the very requirement of data processing was itself undergoing change. If there were a change of legislation or change of the environment either the volumes or the types of processing might vary significantly. The environment is extremely flexible and to compare one with the other as time passed is an apples and pears situation. It is very hard to come up with an exact quantum.[30]

10.21 Despite this assertion, Mr Humphry expressed the view that it was difficult, if not impossible, to compare the anticipated level of savings from outsourcing with

26 Media Release, Minister for Finance and Administration, the Hon John Fahey, 'Industry Development and Savings in IT Outsourcing', 67/97, 7 November 1997.

27 Media Release, Minister for Finance and Administration, the Hon John Fahey, 'Review of the Implementation of the Whole of Government Information Technology Outsourcing Initiative', 01/01, 12 January 2001.

28 Richard Humphry, *Review of the Whole of Government Information Technology Outsourcing Initiative*, Commonwealth of Australia, December 2000, p. 9.

29 ibid., p. 22.

30 Committee, *Hansard*, 7 February 2001, p. 57.

agencies' and departments' bottom line expenditure on IT. This was because 'there were issues that had not been anticipated that had been thrown up which required reclarification of the contract'. Some of these issues meant that departments were involved in out-of-hours work involving additional cost and staff time. He told the Committee: 'The general view I got…was that the process of implementation was very difficult. It was driven by timing that most agencies felt was too tight, and an awful lot of work had to go into creating the right environment as they went forward'.[31]

10.22 While an examination of the ANAO report on the Initiative indicates savings for Cluster 3 and the Australian Taxation Office (ATO), the Humphry Review does not mention the ANAO report's important finding of a 7.3 per cent net cost of $7.5 million to the Group 5 agencies from outsourcing *rather than financial savings*. The Review's attempt to play down the methodology for calculating savings is misleading because the reliability and credibility of estimates for cost savings depends on the soundness of the financial evaluation upon which they are based. This observation will become clear when the extent of ANAO's critique of OASITO's financial methodology is examined in the next section. This issue is very significant because it lies at the centre of the Committee's concern about the real level of savings achieved by agencies, as distinct from the Government's optimistic forward estimates, that were used to make sizeable cuts to the budgets of agencies and departments.

10.23 ANAO agrees that it is not possible to measure precisely the extent of actual savings realised or contributed by the Initiative because of 'changes which have occurred in agency cost structures since the Government's decision, and during the course of the letting of tenders and their evaluation…'[32]

10.24 A similar opinion is provided by the ATO. In the ATO's view, savings have been made as a result of the Initiative, but the amount of savings is 'impossible to quantify with any degree of confidence against the original cost baseline…due to the dynamics of the IT industry and the degree of change in the use of IT within the ATO'.[33] OASITO itself argued that identifying actual savings over a five-year contract for IT services 'would be an extremely difficult and costly exercise' because of the dynamic nature of IT and the changing needs of agencies.[34]

10.25 Nonetheless, OASITO asserted that each of the outsourcing contracts implemented to date (Cluster 3, ATO and Group 5) have delivered cost effective and operationally satisfactory arrangements, with combined savings of around $368 million having been projected for the initial five year contracts.[35] Estimated savings

31 ibid., p. 61.

32 ANAO, *Implementation of Whole-of-Government Information Technology Infrastructure Consolidation and Outsourcing Initiative,* Audit Report No. 9 2000–2001, p. 15.

33 ATO, submission no. 22.

34 OASITO, submission no. 4.

35 *OASITO Annual Report 1999–2000*, p. 23.

for the Health Group and Group 8, according to OASITO, amount to $54 million and $44 million respectively.

10.26 OASITO provided in its submission a simple table that restated the projected levels of savings for each IT contract that were announced by the Minister for Finance and Administration. The figures provided are $60 million (Cluster 3), $10 million (Group 5), $100 million (ATO), $54 million (Health Group), and $44 million (Group 8). OASITO stressed that the projected savings 'were an estimate at a point in time'.

10.27 Given the central role of cost savings in the policy platform for IT outsourcing, the Committee is surprised that OASITO provided only four brief paragraphs on this issue in its written submission totalling forty-four pages. The Committee did not receive any other savings figures from OASITO during the course of the inquiry, and there is no evidence that OASITO attempted to break down savings figures for each cluster and group to show the rate of savings for individual agencies and departments. Apart from figures arising from the ANAO audit of Cluster 3, ATO and Group 5, there is no consolidated set of figures available on savings from IT outsourcing.

10.28 A number of important issues relating to the monitoring and assessment of cost savings from IT outsourcing emerged when the Committee questioned officers from OASITO and DOFA. Dr Boxall advised the Committee that DOFA does not attempt to evaluate any changes in agencies' expenditure on IT compared with the original projected savings under the Initiative. He argued that DOFA does not track this financial movement over time 'because it is the responsibility of CEOs to manage their agency and keep track of how their agency is going, how their contract management is going'.

10.29 In the Committee's view, DOFA's and OASITO's sidestepping of any responsibility for financial outcomes from IT outsourcing points to a serious deficiency in the Government's overall financial management of the Initiative. If, as some evidence suggests, some agencies are required to spend more on their IT costs now compared with when estimates of savings were first announced, then Government must shoulder the responsibility for tracking the inevitable changes to agencies' financial outcomes.[36] Besides, the Committee assumes that in conducting some form of review, DOFA would gauge how effective their methodology was in estimating savings and whether adjustments should be made to the methodology.

10.30 The Committee wishes to highlight the contrast between political statements that trumpeted anticipated savings from IT outsourcing, and the absence of hard data on savings achieved by departments and agencies.

36 ScreenSound, submission no. 11.

Financial methodology

10.31 As noted earlier, according to information provided in DOFA's submission, DOFA, with OGIT, undertook a comprehensive scoping study and evaluation of potential savings to the Commonwealth that would be achieved from a coordinated, consolidated approach to the delivery of IT infrastructure services.[37] The study covered 66 departments and budget-funded agencies and was instigated by the 1996–97 Budget. Detailed questionnaires were sent to 24 agencies:

> The study included a Request for Information to the IT industry relating to 22 large and small agencies. The costs measured by the study represent approximately 95 per cent of total expenditure on IT infrastructure across agencies within the scope of the whole-of-government initiative. The Budget savings were based on conservative assumptions applied to agency baseline costs.[38]

10.32 Apparently, DOFA provided OGIT, and then OASITO, with advice on financial evaluation methodology and data collection models to determine the cost of providing IT infrastructure services in-house, and on competitive neutrality (CN) issues.[39] From November 1997, OASITO was responsible, among other tasks, for developing and applying a financial evaluation model to each of the clusters.[40]

10.33 OASITO advised ANAO during its audit of contracts under the Initiative that it had adopted a financial methodology which assessed the expected financial effect of outsourcing on an agency cash flow basis over the life of a contract, including transitional costs and service charges for equipment and services provided. In other words, OASITO utilised a cash-based, rather than an accrual based methodology.

10.34 An important point that OASITO reiterates in its submission is that its financial evaluation of potential savings was a 'point-in-time' assessment based upon the best estimate of future activities within each agency.[41] After savings in cash outlays attributable to each tenderer had been calculated, notional CN adjustments were added to the agency cost baselines. However, ANAO subsequently noted that it

---

37 DOFA, submission no. 3.

38 ibid.

39 Competitive neutrality requires that 'government business activities should not enjoy net competitive advantages over their private sector competitors simply by virtue of public sector ownership'. The implementation of competitive neutrality policy arrangements is intended to remove resource allocation distortions arising out of public ownership of significant business activities and to improve competitive processes. *Commonwealth Competitive Neutrality Policy Statement, June 1996*. Competitive Neutrality adjustments relate to 'costs faced by private sector providers (and therefore reflected in their prices) that public sector agencies were not subject to, such as a requirement to earn a commercial rate of return on capital and the payment of wholesale sales tax and payroll tax', ANAO, *Implementation of Whole-of-Government Information Technology Infrastructure Consolidation and Outsourcing Initiative,* Audit Report No. 9 2000–2001, p. 18.

40 DOFA, submission no. 3.

41 Committee, *Hansard*, 7 February 2001, p. 110.

was ‘unable to verify the accuracy of the CN adjustments calculated for each of the tenders reviewed due to the absence of complete working papers supporting the calculation of those adjustments’.[42]

10.35 The Committee believes that the validity of the expected savings estimates must ultimately rest upon the soundness of the proposed financial methodology, and the consistent application of that methodology for each tender process. ANAO, however, has conveyed serious reservations about OASITO’s views on the residual value of assets, and has highlighted inconsistencies in the financial methodologies used for IT outsourcing.

10.36 ANAO’s report provided a detailed critique of the financial methodology used by OASITO for the Initiative. The methodology employed in determining the direct financial savings that agencies could expect formed a key part of the analysis of financial evaluations undertaken for each tender. The core issue for ANAO was that the financial methodology adopted for the Initiative by OASITO did not take into consideration two issues that would have a material impact on the assessment of cost savings. They were that:

- the fair market value of agency residual assets was not included; and
- the cost to agencies arising from the Commonwealth’s guarantee of external service provider asset values under outsourcing was not calculated.[43]

ANAO presents a persuasive case as to why these should have been included in the financial evaluations.

10.37 It provided the Committee with important background to the financial processes that have applied in the Australian Public Service over many years. ANAO referred to a 1993 Department of Finance (DOF) report which argues that the residual value of assets purchased by the Commonwealth must be accounted for.[44] According to Mr Cronin, Executive Director, Performance Audit, ANAO, a Finance circular issued in 1993–94 ‘gave credence to that document replacing the previous Public Service Board document’. He told the Committee that the issue ANAO has with OASITO relates to the measurement of cash and particularly to the question of residual values on assets. He pointed out that ‘this residual value must be accounted for in the cash flow or the purchase option’. He was supported in this assessment by the Deputy Auditor- General, Mr Ian McPhee, who stated:

> What we are proposing I do not think is anything very innovative. As Mr Cronin mentioned, this approach has been around for a very long time, and

---

42 ANAO, *Implementation of Whole-of-Government Information Technology Infrastructure Consolidation and Outsourcing Initiative,* Audit Report No. 9 2000–2001, p. 151, fn. 149.

43 ibid., p. 152–53.

44 Committee, *Hansard*, 5 December 2000, p. 11.

> supported by the earlier Finance publications, which is entirely consistent with the analysis we adopted in our report.[45]

10.38 ANAO maintains that the value of terminal assets can be a significant component of any analysis. Thus the classification of the lease arrangements has important consequences in financial evaluations. In this case, ANAO and OASITO disagreed over whether leases involved in the financial evaluation of IT outsourcing should be classified as finance or operating leases.[46] OASITO classified its leases as operating leases.

10.39 ANAO cited an international discussion paper on accounting for leases that is 'currently under exposure in Australia'. The ANAO states clearly that it supports the paper's underlying position with regard to the finance lease/operating lease issue. It is important to quote ANAO's perspective in full:

> The international paper makes the point that in practical terms the differences between operating and finance leases are quite often very few and that a similar lease could be construed to be an operating or a finance lease, depending upon how it is looked at and how it is interpreted. So the paper recommends that all leases be accounted for as finance leases in the future. In this situation, that would mean that the leased assets would be recognised by the agencies in question and a corresponding liability would be recognised in the financial statements.[47]

10.40 ANAO advised the Finance and Public Administration Legislation Committee that in undertaking its assessment of the cost savings issue it received advice 'from two of the most prominent experts in accounting standards in this country' on the treatment of leases.[48]

10.41 In OASITO's opinion the service agreement entered into by the Commonwealth for the Initiative represents an *operating lease* and not a *finance lease* within the context of Australian Accounting Standards. Officers from OASITO were questioned about the issue of operating and finance leases at the November 2000

---

45 ibid.

46 According to the Australian Accounting Standard 17, para 20, a finance lease means a lease under which the lessor effectively transfers to the lessee substantially all the risks and benefits incident to ownership of the leased asset and where legal ownership may or may not eventually be transferred. An operating lease means a lease under which the lessor effectively retains substantially all the risks and benefits incident to ownership of the leased asset.

47 Committee, *Hansard*, 5 December 2000, p. 14.

48 Finance and Public Administration Legislation Committee, *Hansard*, 22 November 2000, p. 50. Copies of advice sought by ANAO on this issue were subsequently made available at the request of this Committee. The advice was provided by Ms Ruth Picker from Ernst & Young, who at the time was a member of the Australian Accounting Standards Board which is responsible for the development of accounting standards within Australia. It included a review of the Group 5 agreement, and two additional reviews of the leasing arrangements for the Initiative taking account of independent legal advice provided to OASITO, and advice provide to DOFA by KPMG. Additional information, Ernst & Young to ANAO attachments A–C, requested 5 December 2000.

estimates hearings. They, however, were unable to discuss the difference between the two types of leases.[49]

10.42 Mr Yarra was asked to 'provide the committee with a full explanation [of the difference] in accounting terms with reference to what they have got to do with your contracts'. The explanation provided consisted of a lengthy extract from Australian Accounting Standard 17 (AAS 17, October 1998) which provides a detailed explanation of the difference between an operating and finance lease. The answer concludes with the following confident statement: 'OASITO, based on expert legal and financial advice maintains that the ITO contracts are not finance leases. They are service contracts, or, if bifurcated, operating leases'.[50]

10.43 In analysing the legal and financial advice provided separately to OASITO and DOFA, ANAO concluded: 'We remain of the view that…it is appropriate to treat the assets provided to, and used by, Group members under the Agreement as finance leases'.[51]

10.44 The Committee wishes to point out that DOFA's responses to the ANAO report make no attempt to address, let alone engage with, the range of arguments developed in the ANAO report. It is disappointed that an agreed position could not be reached on the question of financial metholologies and is left with the impression that DOFA and OASITO have chosen to hide behind external advice as the basis for rejecting ANAO's recommendations.

10.45 ANAO's detailed critique of OASITO's methodology resulted in two key findings that:

- the direct cost savings from IT outsourcing achievable by agencies, in comparison to retaining the existing internal delivery of services, were overstated and the true financial value to the Commonwealth of entering into the outsourcing arrangement was not revealed by the financial evaluation undertaken; and[52]

---

49 Finance and Public Administration Legislation Committee, *Hansard*, 28 November 2000, p. 267.

50 Finance and Public Administration Legislation Committee, Budget Estimates 2000–2001, Additional Information Received, Volume 2, May 2001, p. 360. The legal and financial advice sought by OASITO on financial methodologies was provided from Deloittes Touche Tohmatsu, PricewaterhouseCoopers, Walter and Turnbull, Blake Dawson Waldron and Spectra Financial Services. On a separate occasion, Dr Boxall confirmed that DOFA did seek advice from KPMG in the context of preparing the Commonwealth's consolidated financial statements for 1999–2000, on whether the IT outsourcing service contracts contained embedded finance leases. It had not, however, sought any other independent advice in relation to financial methodologies. Committee, *Hansard*, 7 February 2001, p. 113.

51 Additional information, ANAO to Group 5 Agencies attachment D, requested 5 December 2000.

52 ANAO, *Implementation of Whole-of-Government Information Technology Infrastructure Consolidation and Outsourcing Initiative,* Audit Report No. 9 2000–2001, p. 154.

- there was an overall cost to Group 5 agencies rather than a saving, taking into account an estimate of Fair Market Value (FMV) of end-of-period agency assets at 50 per cent of Net Book Value (NBV).[53]

10.46 In light of these findings the ANAO report made two recommendations that specifically address the issue of the value of residual assets and the extent of Commonwealth obligations vis-à-vis underwriting tenderers' asset risk:

> **Recommendation No 12 Para 7.17**: ANAO *recommends* that, in order for the evaluation to identify the true financial value to the Commonwealth of future IT outsourcing tenders, relevant agencies include, at a minimum, the estimated fair market value of agency residual assets that provide service potential beyond the evaluation period.
>
> **Recommendation No 14 Para 7.44**: ANAO *recommends* that, for future IT outsourcing tenders, relevant agencies properly account in the financial evaluation for any residual end-of-term Commonwealth obligations arising from underwriting tenderers' asset risk associated with the outsourced services.[54]

10.47 Given the difference of opinion between DOFA/OASITO and ANAO over the financial evaluation methodology issue, the Committee is not surprised to find that the DOFA/whole-of-government-response disagreed with both ANAO recommendations. The response to recommendation 12 states:

> The methodology used for the implementation of the IT Outsourcing Initiative does not include this residual asset value. This methodology is consistent with independent expert advice obtained by OASITO and applicable Government policy, although some agencies have noted an alternative approach.[55]

10.48 The response to recommendation 14 states, in part, that the base financial evaluation should not include a contingent liability in relation to end of term assets. Again, DOFA argues that 'This treatment is consistent with expert advice obtained by OASITO and consistent with Government policy on IT outsourcing'.

10.49 The Committee believes that these are unsatisfactory responses, not least because they do not address the substance of ANAO's concerns. Moreover, the advice received by ANAO from Ernst & Young on 5 July and 2 August 2000 makes abundantly clear that the independent expert advice provided to OASITO and DOFA is equivocal precisely on the financial methodology issue. Both pieces of written analysis by Ernst & Young arrive at the same conclusion. The 2 August advice, for example, states:

---

53 ibid.

54 ibid., p. 32.

55 ibid., p. 156.

> We have reviewed the accounting opinion provided by KPMG to the Department of Finance and Administration in relation to the IT outsourcing Agreement and advise that we still hold the opinion that the Agreement relating to the IT equipment is essentially a finance lease.[56]

10.50 The Committee expresses its dissatisfaction with the situation that two Commonwealth bodies such as DOFA and ANAO have not been able to agree on a methodology. It expects that in a devolved environment agency heads in establishing their business case for IT outsourcing will review this matter and carefully analyse the methodology for estimating costs and savings.

Savings in the broader context

10.51 It is significant that in their respective submissions to the inquiry, DOFA and OASITO argue that while the total amount of savings has been the subject of much controversy, that savings have been made is not in dispute. The Auditor-General said, in part: '…on the face of our arithmetic, there are still significant savings to be made from this initiative'. Of concern to the Committee is the fact that the comments by the Auditor-General are quoted out of context and distort a broader point he was making about policy justifications for the Initiative, which followed on immediately from his brief comment on savings:

> The question for the decision makers then becomes whether they can pocket those savings, but also, more particularly, if they are not as great as they thought, that puts a much greater weight on any other aspects of justification for the outsourcing initiative. That needs to be looked at…[57]

10.52 The Committee is concerned that OASITO's tendency to use selective quotes on the cost savings issue overlooks less than flattering savings figures that have been provided to the Committee by various department and agencies.

10.53 In their submissions OASITO and DOFA draw on selective information that, on the surface, lends support to their position, but ignores important evidence highly critical of the savings methodology that formed part of the financial framework for the Initiative.

10.54 The Committee is convinced that the analysis and critique undertaken by ANAO, in addition to the evidence it has received during the course of the inquiry, cast some doubt over the level of savings that have been realised to date and are likely to be achieved in the future. It also finds unsatisfactory a situation where it is not possible to measure, with any precision, the extent of actual savings from IT

56 Additional information, Ernst & Young to ANAO attachment C, requested 5 December 2000, provided 21 December 2000.

57 Finance and Public Administration Legislation Committee, *Hansard*, 22 November 2000, p. 50. The Auditor-General, Mr P. Barrett, made the same observation to the Committee at the 5 December hearing. See Committee, *Hansard*, pp. 23–24.

outsourcing to date. This, by itself, is a significant shortcoming with a major policy initiative predicated on reductions to the forward estimates of agency budgets.

10.55 The Committee believes ANAO’s analysis of cost savings demonstrates serious deficiencies with OASITO’s financial management of the Initiative that need to be addressed in future IT outsourcing tenders. Many of the shortfalls with the methodology and policy assumptions of the financial evaluations became apparent to the Committee when it sought the views of a range of agencies and departments involved in the Initiative.

Agency and department views on savings

Introduction

10.56 This section focuses on the financial experience of various agencies and departments participating in the Initiative. The Committee has made an effort, based on the evidence, to arrive at a more considered view of the superficial figures that have been provided by Minister Fahey at the announcement of each outsourcing contract.

10.57 In an effort to quantify savings realised from the Initiative, the Committee sought from a number of agencies specific information relating to their respective cost savings. The agencies questioned by the Committee are spread over Cluster 3, Group 5, Group 8, Group 10 and the Health Group. In each instance the Committee referred the agency to Figure 6.1 of the ANAO report on the Initiative reproduced below. The figure is a small table providing a five-year comparison of agency Budget reductions to contractual outcomes for Cluster 3, ATO and Group 5, based on a combination of OASITO documentation and ANAO analysis. Officers from six departments and agencies were asked to provide a set of figures on estimated cash outlays under the Initiative. These are Health and Aged Care (DHAC), Health Insurance Commission (HIC), Transport and Regional Services (DTRS), Civil Aviation and Safety Authority (CASA) and the Australian Federal Police (AFP). These agencies and departments were also questioned about the extent of budget reductions that could be attributed to IT outsourcing.

Figure 5: Five year comparison of agency Budget reductions to contractual cash outcome (excluding voice network and applications development & maintenance)

	Estimated savings in cash outlays under Agreement ($m)	**Agency cash Budget reductions ($m)**	**Cash difference ($m)**
Cluster 3	55.3	33.4	21.9
ATO	39.1[1]	76.3[2]	(37.2)
Group 5	0.3	9.6	(9.3)
Total	94.7	119.3	(24.6)

Note 1: The ATO tender evaluation projected direct financial savings to ATO of $42.7 million at final contract stage (excluding voice network). Due to the CN methodology applied, this did not include sales tax costs of $3.6m included in the contracted pricing. Although neutral at a whole-of-Government level, those costs are relevant for the purposes of comparing the ATO's expected cash outcomes under the outsourcing Agreement with the cash budget reductions and are included in this analysis.

Note 2: Excludes Budget reductions of $1.86m applied in 1998-99 prior to contract commencement.

Source: Cluster 3, ATO and Group tender evaluation reports, OASITO documentation and ANAO analysis

Source: ANAO, *Implementation of Whole-of-Government Information Technology Infrastructure Consolidation and Outsourcing Initiative*, Audit Report No. 9 2000-2001, p. 130.

10.58 The information requested included figures relating to taxation liabilities and any analyses of savings that had been undertaken by agencies. Few agencies, however, were able to provide detailed answers to these specific questions. It is noteworthy that at the hearings few of the witnesses could provide the Committee with reliable data or recall fairly basic figures, such as the estimates of savings or savings that their agency had or had not achieved. This lack of detail impeded the Committee's ability to investigate more carefully assumptions underpinning the financial evaluation methodology used by OASITO to calculate estimated savings from IT outsourcing. Agencies, however, were cooperative and agreed to take on notice many of the questions relating to cost savings that could be answered only in part or not at all.

Evidence

10.59 The information that was subsequently provided to the Committee varies in its quality and detail and is, at best, patchy. For example, DHAC informed the Committee that it achieved savings to the value of $16.5 million (including adjustments made by DOFA). Of this amount, approximately $13 million related to competitive neutrality considerations.[58] The HIC advised that savings attributable to it under the Health Group totalled $37.62 million over the five years of the contract, which represented $16.85 million for competitive neutrality and $20.77 million in cash. Revenue payments to the HIC from DHAC were reduced in 1999–2000 and 2000–01 by $3 million each year in respect of anticipated savings.[59]

10.60 DTRS experienced budget reductions totalling $394 000 in 1999–2000 and $764 000 in future years. While the department stated that the calculation of savings was ‘basically budget neutral’, meaning it achieved no savings, it was subsequently revealed that outsourcing actually cost the department approximately $100 000 per year. The department argued that although it was not going to experience any savings from IT outsourcing ‘there were considered to be other advantages to the department by proceeding with the arrangement’, not least that savings were calculated on a Group basis and ‘there were overall savings for group 5’—a point which is disputed in the analysis undertaken by ANAO.[60]

10.61 The estimate of savings for CASA under OASITO’s financial model is just over $5 million (of which approximately $3 million is attributed to competitive neutrality). However CASA informed the Committee that it had carried out its own evaluation of estimated savings and the figures were ‘less than the OASITO model’ because CASA felt that it ‘did not take account of some elements of cost that would apply to an agency specifically’.[61] In fact the figure was just under $1 million in ‘negative savings’, which means CASA incurred additional costs over a five year period (the extent of these costs was not revealed). Mr Comer, Executive Manager, Corporate Services, expressed the view that there was a ‘marginal business case’ for CASA to outsource based on its own evaluation of estimated savings.

10.62 The Committee also took evidence from the Public Service and Merit Protection Commission (PSMPC) about its expected level of cost savings within Group 8 at an earlier hearing on 17 May. Apparently OASITO attributed savings to PSMPC in the order of $180,000 over the five-year contract, which was $68,000 higher than the dollar figure cut from PSMPC’s budget allocation. However, when asked: ‘do you expect to be able to combine your costs to achieve any savings at all’, Mr Jones responded: ‘I think it is difficult to attribute a saving … [because] the cost of IT, just by its nature, increases year by year. And it would continue to increase, no matter who your provider was’.[62]

10.63 Additional information on cost savings is provided in a number of written submissions. ScreenSound Australia, for example, provided a limited set of figures. In

58 Answer to question on notice, 9 March 2001.

59 ibid.

60 Committee, *Hansard*, 9 March 2001, p. 174.

61 ibid., p. 194.

62 Committee, *Hansard*, 17 May 2001, p. 484.

cash terms, the outsourcing of IT cost the organisation over $150,000 more per annum than it did when the services were provided in-house. This meant that in the short term 'this cost has deflected funds from other Archive priorities'.[63] The Bureau of Meteorology also indicated that the reduction to its forward estimates of $917,000, commencing with the 2000–01 financial year, had to be absorbed by an across the board cut 'thereby diminishing marginally operational effectiveness in all areas of the Bureau'.[64] As part of Group 9, the Humphry Review recommended that this Group not proceed with its IT outsourcing unless certain risks can be addressed.

10.64 The Department of Immigration and Multicultural Affairs (DIMA) provided the most detailed figures on cost savings. Over the period 1998–2003 budget reductions were in the order of $14.7 million with projected savings for the corresponding period totalling $19.8 million, which represents 31 per cent of the projected Cluster 3 savings of $64.4 million (the difference between budget cuts and expected savings, therefore, is $5.1 million). DIMA advised the Committee that:

> During the conduct of the ANAO audit the Cluster provided additional information to assist ANAO in analysing the savings realised. The Cluster undertook a high level analysis which determined unit costs in the year preceding the IT Outsourcing initiative and compared these with unit rates being charged by the outsourcer. The relevant unit cost was then multiplied by the volume of resources used in the first year of operation of the Cluster 3 Agreement.[65]

10.65 The outcome of this high level analysis showed that in DIMA's case, in the first year of the arrangement, there were notional savings of approximately $3.9 million against an adjusted baseline expenditure of $29.1 million, which gives a savings rate of 13 per cent. However, the 'projected savings rate for DIMA was 17 per cent'.[66]

10.66 AFP in its submission highlighted savings from outsourcing in the order of $1.2 million before the IT Initiative. However, under the Initiative, the AFP's base funding was reduced over several years including $1.5 million for the 1999–2000 financial year, 'regardless of the fact that most opportunity for savings had already been realised in 1996/7' and the OASITO process had not by then 'been able to offer any actual cost savings'.[67] The Committee also notes the more concerned tone of the AFP submission to the Humphry Review. On the issue of cost savings:

> The AFP assesses likely savings to Government from the outsourcing of AFP IT services are negligible. Indeed, the need for operations

---

63 ScreenSound Australia, submission no. 11.

64 Bureau of Meteorology, submission no. 17.

65 Answer to question on notice, 15 March 2001.

66 ibid.

67 Australian Federal Police (AFP), submission no. 20.

> responsiveness and flexibility…is likely to increase costs in an outsourced environment…The AFP's budget has already been cut by $1.5 million in the current financial year in 'anticipation' of the now delayed OASITO process…this could not be [achieved] before 2002, and AFP strongly rejects the validity of OASITO's savings assessment.[68]

10.67 The Committee's experience in receiving patchy information on cost savings is consistent with the poor level of information that has been provided separately to the Finance and Public Administration Legislation Committee by the Department of the Prime Minister and Cabinet (PM&C) and the Australian Electoral Commission (AEC). When asked if IT outsourcing has been cost effective, PM&C responded: 'To date, the cost of IT&T [information technology and telecommunications] services…after outsourcing has remained within overall expectations'. Figures to support this claim were not attached and when asked if, in PM&C's view, OASITO's projections of cost savings were accurate, the Committee received in writing the following blunt answer: 'not applicable'.[69] Similarly, the AEC, when questioned about the cost-effectiveness of outsourcing, responded in writing: 'AEC considers that outsourcing has been cost effective and has provided a range of benefits', which it proceeded to list. But the AEC did not provide any figures to substantiate the claim of cost effectiveness.[70]

10.68 Taking into consideration all the available evidence relating to cost savings, including evidence provided to the Finance and Public Administration Legislation Committee, the Committee still is unable to formulate a clear picture of projected savings from IT outsourcing and make meaningful comparisons across agencies and departments. This situation has come about in part because the Committee has been unable to obtain a consistent and reliable set of figures on cost savings either from OASITO or the agencies.

10.69 The information on cost savings that the Committee was able to obtain is nonetheless telling. Since the inception of the Initiative the Government has been persistent in claiming significant savings from IT outsourcing on a whole-of-government basis. However, it is now clear to the Committee that notwithstanding savings anticipated for each group or cluster, a number of agencies and departments from Group 5, Group 8, Group 10 and the Health Group have already experienced no savings or have incurred costs that were not taken into consideration in the original financial evaluations undertaken by DOFA/OASITO. This important fact has been ignored in much of the official rhetoric on 'substantial savings' from IT outsourcing and is repeated but not substantiated by OASITO in its 1999–2000 annual report and by Mr Humphry in his Review.

---

68 AFP, submission to the Humphry Review.

69 Finance and Public Administration Legislation Committee, answer to question on notice, 23 February 2001.

70 ibid.

10.70 As noted, however, in chapter three, the focus on cost savings did broaden over time to include other benefits from IT outsourcing and now 'value for money' is without doubt a key consideration.[71]

10.71 In summary, the Committee welcomes the change in the stated objectives of the Initiative which shows a shift in emphasis from achieving substantial cost savings to obtaining overall value for money. The RFTs for both Group 1 released on 15 December 1999 and for Group 11 released on 12 September 2000 stipulate:

> The tender evaluation is designed to select the tender that offers the best overall 'value for money' consistent with efficiently and effectively meeting the business needs of each Group Agency.[72]

10.72 The Committee hopes that the Government's focus remains on the objective of achieving best value for money and does not resort again to the requirement that the achievement of substantial cost saving be a precondition to the award of a contract. Furthermore, the Committee rejects outright the use of the big stick of budget cuts to pressure agencies to outsource their IT.

10.73 In turning to the methodology used to estimate savings, the Committee can only urge DOFA to produce figures that are open to public scrutiny and can be tested independently. The Committee believes it would be more constructive for DOFA to work with organisations such as the ANAO to agree on a methodology for estimating cost savings and to produce a reporting regime that informs not obfuscates.

Recommendation No. 22

The Committee recommends that the Commonwealth adopt an open and transparent methodology for estimating cost savings for IT outsourcing. In developing this methodology, all relevant Commonwealth agencies, including ANAO and DOFA, are to be consulted, and a common methodology adopted.

71 See para 3.5 and 3.6.

72 See also paras 3.6 and 3.7 and footnote no. 6 in Chapter Three.