

The Auditor-General  
Audit Report No.32 2008–09  
Performance Audit

# **Management of the Tendering Process for the Construction of the Joint Operation Headquarters**

**Department of Defence**

© Commonwealth  
of Australia 2009

ISSN 1036-7632

ISBN 0 642 81064 8

### **COPYRIGHT INFORMATION**

This work is copyright. Apart from any use as permitted under the *Copyright Act 1968*, no part may be reproduced by any process without prior written permission from the Commonwealth.

Requests and inquiries concerning reproduction and rights should be addressed to:

Commonwealth Copyright  
Administration  
Attorney-General's Department  
3-5 National Circuit  
Barton ACT 2600

<http://www.ag.gov.au/cca>



Canberra ACT  
19 May 2009

Dear Mr President  
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Department of Defence in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *Management of the Tendering Process for the Construction of the Joint Operation Headquarters*.

Following its tabling in Parliament, the report will be placed on the Australian National Audit Office's Homepage—<http://www.anao.gov.au>.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian McPhee'.

Ian McPhee  
Auditor-General

The Honourable the President of the Senate  
The Honourable the Speaker of the House of Representatives  
Parliament House  
Canberra ACT

## AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

For further information contact:

**The Publications Manager**  
**Australian National Audit Office**  
**GPO Box 707**  
**Canberra ACT 2601**

**Telephone:** (02) 6203 7505  
**Fax:** (02) 6203 7519  
**Email:** [webmaster@anao.gov.au](mailto:webmaster@anao.gov.au)

ANAO audit reports and information about the ANAO are available at our internet address:

<http://www.anao.gov.au>

# Contents

---

Abbreviations.....	8
<b>Summary .....</b>	<b>11</b>
Summary .....	13
Introduction .....	13
Audit approach .....	16
Conclusion .....	19
Key findings.....	28
Responses to the proposed report.....	36
<b>Audit Findings and Conclusions .....</b>	<b>39</b>
1. Introduction .....	41
Background .....	41
Project inception.....	43
Project objective.....	45
Project elements .....	46
Public Private Partnerships.....	46
Audit objective and approach.....	48
Report structure .....	50
2. Procurement Framework.....	51
Introduction .....	51
Government procurement framework .....	51
Public sector comparator (Project Cost Benchmark).....	58
3. Tender Process.....	64
Introduction .....	64
Project tender documents .....	64
Organisational structure for the tender evaluation.....	66
The tender: a four stage process .....	69
4. Decision on Preferred Tenderer.....	93
Introduction .....	93
Implementing the Government’s decision on the preferred tenderer for the Project.....	93
Importance of the tax treatment.....	94
5. Negotiation and Contract Development.....	114
Introduction .....	114
Negotiation with the Prime Contractor .....	115
Financial approvals .....	129
6. Payment Schedule .....	133
Introduction .....	133
Annual service payments.....	133

7. Probity Management.....	146
Introduction .....	146
Probity guidance for Australian Government procurement.....	146
Probity arrangements for the Project .....	147
Tender process—two significant probity matters.....	153
<b>Appendices .....</b>	<b>159</b>
Appendix 1: Defence’s Comments on the Proposed Report.....	161
Appendix 2: Praeco Pty Limited’s Comments on the Proposed Report.....	163
Appendix 3: Glossary.....	167
Series Titles.....	171
Current Better Practice Guides .....	175

## Tables

Table 1	Summary of tender rounds and consortia responses after the Request for Tender was issued.....	20
Table 1.1	HQJOC Project: key dates and events at inception .....	43
Table 2.1	Cost of external HQJOC Project advisers .....	54
Table 2.2	Key events in the development of the HQJOC Project Cost Benchmark .....	61
Table 2.3	Finalising the HQJOC Project Cost Benchmark.....	62
Table 3.1	Evaluation organisation bodies: membership and responsibilities.....	67
Table 3.2	Tender schedule: planned and actual dates .....	70
Table 3.3	Tenderers’ responses to the HQJOC Request for Tender AZ 2931 (issued 1 September 2004) .....	77
Table 3.4	Tenderers’ responses to the HQJOC Request for Revised Offer AZ 3100 (issued 2 May 2005) .....	80
Table 3.5	Tenderers’ responses to the HQJOC Request for Final Revised Offer AZ 3206 (issued 24 October 2005) .....	86
Table 3.6	Financial Tender Evaluation Working Group’s Net Present Cost calculation and final ranking of tenderers’ Request for Final Revised Offer responses, February 2006 .....	87
Table 4.1	Tenderers’ proposed tax arrangements during the tender process .....	99
Table 4.2	Commercial Tender Evaluation Working Group ranking of Request for Final Revised Offer Tender Responses .....	102
Table 5.1	The Prime Contractor’s revised costing for ATR2—assuming the preferred tenderer was announced by 31 May 2006 .....	119
Table 5.2	HQJOC Project Cost Benchmark comparison with the Prime Contractor’s Alternative Tender Response 2 .....	123
Table 5.3	Defence’s compliance with the FMA Regulations relating to commitments to spend public money for the HQJOC Project.....	131

Table 6.1	Comparison of HQJOC annual service payments .....	140
Table 7.1	Summary of probity related audit findings identified in the Risk Management Adviser's audit report, February 2007 .....	152

**Figures**

Figure 1	Audit scope .....	18
Figure 1.1	Key objectives for the HQJOC Project .....	45
Figure 1.2	Defence's perspective: advantages of a PPP for the HQJOC Project.....	48
Figure 3.1	HQJOC tender evaluation organisation.....	66
Figure 3.2	Tender evaluation process .....	72
Figure 4.1	<i>Income Tax Assessment Act 1936</i> : anti-avoidance provisions for leasing .....	96
Figure 4.2	Benefits and limitations of Defence's approach to the HQJOC Project's tax treatment.....	104
Figure 6.1	Timeline for HQJOC Project annual service payments.....	136

# Abbreviations

---

ABC	Acquisition Business Case
ADF	Australian Defence Force
AGS	Australian Government Solicitor
ANAO	Australian National Audit Office
ATO	Australian Taxation Office
ATR	Alternative Tender Response
C4I	Command, control, communications, computing and intelligence systems
CDF	Chief of the Defence Force
CEI	Chief Executive Instructions
CIU	Cabinet Implementation Unit
COI	Conflict of Interest
CPG	Commonwealth Procurement Guidelines
CPI	Consumer Price Index
D&C	Design and Construction
Defence	Department of Defence
DG HQJOC Project	Director General Headquarters Joint Operations Command Project
DMO	Defence Materiel Organisation
DSG	Defence Support Group



DPPM	Defence Procurement Policy Manual
Finance	Department of Finance and Deregulation (formerly the Department of Finance and Administration)
FMA Act	<i>Financial Management and Accountability Act 1997</i>
FMA Orders	Financial Management and Accountability Orders
FMA Regulations	Financial Management and Accountability Regulations 1997
GDP	Gross Domestic Product
GST	Goods and Services Tax
HQJOC	Headquarters Joint Operations Command
HQAST	Headquarters Australian Theatre
IASP	Indexed annual service payment
ITAA	<i>Income Tax Assessment Act 1936 and 1997</i>
ITR	Invitation to Register Interest
NAO	National Audit Office (United Kingdom)
NIASP	Non-indexed annual service payment
NPC	Net Present Cost
NPV	Net Present Value
PCB	Project Cost Benchmark
PFI	Private financing initiative
PGB	Project Governance Board
PM&C	Department of the Prime Minister and Cabinet

PPP	Public Private Partnership
PWC	Parliamentary Standing Committee on Public Works
RFRO	Request for Final Revised Offer
RFT	Request for Tender
RRO	Request for Revised Offer
STR	Standard Tender Response
TEB	Tender Evaluation Board
TEP	Tender Evaluation Plan
TEWG	Tender Evaluation Working Group
VFM	Value for money

# Summary



# Summary

---

## Introduction

1. The selection of a site in rural New South Wales, south of Sydney and near Canberra, for the construction of a new purpose-built operational military headquarters for the Australian Defence Force (ADF) was announced by the then Prime Minister, the Hon. John Howard MP, on 3 October 2001.<sup>1</sup>
2. The Department of Defence (Defence) is responsible for the Headquarters Joint Operations Command (HQJOC) Project. The Project was established to create a new facility to enable the ADF to more effectively plan and conduct its operations, and other activities such as support for national and international disaster relief.
3. The new HQJOC facility was officially opened by the Prime Minister, the Hon. Kevin Rudd MP on 7 March 2009. The facility replaces a number of existing transitional facilities and staffing arrangements and accommodates approximately 750 members of the ADF and the Australian Public Service in a single location.<sup>2</sup> In total, the financial modelling for the Project, completed in July 2006, determined that the whole of life Net Present Value (NPV) of the selected private sector consortium providing the buildings, infrastructure and services over the Project's 30 year term was \$572.2 million (2006–07 Budget prices, outturned).<sup>3</sup> The new facility was formally handed over by its private sector construction company to Defence in July 2008.<sup>4</sup> Following the separate installation of the command, control, communications, computing and

---

<sup>1</sup> Available from <<http://www.defence.gov.au/id/hqjoc/news.htm>> [accessed 3 November 2008].

<sup>2</sup> The Prime Minister's opening speech is available from <[http://www.pm.gov.au/media/Speech/2009/speech\\_0860.cfm](http://www.pm.gov.au/media/Speech/2009/speech_0860.cfm)> [accessed 10 March 2009].

<sup>3</sup> 'Net Present Value' (NPV) is the future cash flows, discounted for timing and risk, less the cost of investing in the project calculated in terms of today's worth. Outturned prices are estimates adjusted to incorporate the expected rate of inflation. Defence announced in 2006 that the nominal whole of life cost for the 30 year project is \$1.2 billion (Goods and Services Tax (GST) exclusive, in 2006–07 Budget prices outturned).

<sup>4</sup> Parliamentary Secretary for Defence Support, the Hon. Dr Mike Kelly MP, Media Release *Headquarters Joint Operations Command Project – Completion of Construction* [Internet]. Department of Defence, Canberra, 11 July 2008, available from <<http://www.defence.gov.au>> [accessed 11 July 2008].

intelligence systems (C4I), the facility was available for full occupation and use by Defence from November 2008.<sup>5</sup>

## **Project delivery model: Public Private Partnership**

4. In March 2004, the then Government approved Defence proceeding with the Project using a Public Private Partnership (PPP) as the Project's delivery model.<sup>6</sup> The Government's approval for Defence's use of a PPP was conditional on the arrangements achieving superior value for money (VFM) compared to the alternative of proceeding with the Project using traditional direct procurement. The Project is the first where the Australian Government<sup>7</sup> has used a PPP to both construct and maintain a major facility on a greenfield site.<sup>8</sup>

5. Defence commenced an open tender process for the Project in April 2004 that culminated in May 2006 with the Government announcing that a private sector company, Praeco Pty Limited (the Prime Contractor), was the preferred tenderer to design, construct, finance, operate and maintain the facility via a PPP.<sup>9</sup> Defence signed a contract for delivery of the Project, on behalf of the Commonwealth, with the Prime Contractor on 30 June 2006—effective for 30 years, to 30 June 2036. Ownership of the facility transfers to Defence at the end of the contract's 30 year term.

---

<sup>5</sup> Parliamentary Secretary for Defence Support, the Hon. Dr Mike Kelly MP, Media Release *Headquarters Joint Operations Command Project – Facilities Handover* [Internet]. Department of Defence, Canberra, 14 November 2008, available from <<http://www.defence.gov.au>> [accessed 14 November 2008]. Defence has also directly contracted with ADI Limited (trading as Thales Australia) to deliver the Project's command, control, communications, computing and intelligence systems (C4I). The value of the C4I contract will be up to \$58.5 million (GST exclusive, in 2006–07 Budget prices).

<sup>6</sup> The Australian Government defines PPPs as:

a form of government procurement involving the use of private sector capital to wholly or partly fund an asset—that would have otherwise been purchased directly by the government—which is used to deliver Australian Government outcomes.

Department of Finance and Deregulation, *Australian Government Policy Principles for the Use of Public Private Partnerships - FMG 21* [Internet]. Department of Finance and Deregulation, Canberra, 2006, available from <<http://www.finance.gov.au>> [accessed 27 June 2008].

<sup>7</sup> In Australia, state governments have used PPPs for roads, tunnels, hospitals, prisons and schools. Other examples of the use of PPPs from overseas include waste facilities, construction of government offices, train infrastructure, defence facilities and airports. International Federation of Accountants, *Service Concessions / PPPs*, IFAC, Montreal, 2007, pp. 20–21.

<sup>8</sup> 'Greenfield' is a term used to describe undeveloped land.

<sup>9</sup> Praeco Pty Limited (Leighton Contractors, Leighton Services and Boeing Australia Limited, which was later replaced by ABN AMRO) is referred to as the Prime Contractor in this report.

## Assessing value for money

6. VFM is assessed through a comparative analysis of all relevant costs and benefits over the entire life cycle of a project. When evaluating a private financing proposal, VFM is tested by comparing the outputs and costs of private financing proposals against a neutral benchmark, called the public sector comparator (referred to by Defence as the Project Cost Benchmark (PCB)). In consultation with the then Department of Finance and Administration (Finance),<sup>10</sup> Defence and its project advisers developed and used a PCB for the HQJOC Project.<sup>11</sup>

7. The development of a PCB and the evaluation of the relative VFM of the tender responses for a PPP as compared to the PCB involve the identification of relevant costs and risks, and then the development of estimates of the Net Present Cost (NPC)<sup>12</sup> of these costs and risks. The decision as to whether or not undertaking a proposal through a PPP, as opposed to a direct procurement process, will offer superior VFM is made taking into account the comparison between the estimated NPC of the PCB and the estimated NPC of the various PPP tender responses received. Defence engaged a range of external expert advisers, at a total cost of some \$15.7 million,<sup>13</sup> to assist it in undertaking the tasks associated with evaluating the best approach to delivering the HQJOC Project, including the development of the PCB and the calculation of the estimates of the NPC of the various tender responses received.

8. Defence advised the then Senate Foreign Affairs, Defence and Trade Legislation Committee in June 2006 that the fact the proposed PPP financing

---

<sup>10</sup> Following changes to the Administrative Arrangements Order on 25 January 2008 the Department of Finance and Administration became the Department of Finance and Deregulation. The same contraction is used for both names for the department, Finance.

<sup>11</sup> Defence's *Private Financing Manual* (2002) defines the PCB as an estimate of the whole of life cost of delivering a capability where Defence buys the capital equipment and facilities and then supports ongoing delivery of the service needed to provide that capability. The estimate should be based on the most cost effective method and may include the use of outsourced maintenance and service delivery.

<sup>12</sup> 'Net Present Cost' is the equivalent cost at a given time of a stream of future net cash outlays (calculated by discounting the values at the appropriate discount rate).

<sup>13</sup> See Table 2.1 for a listing of Defence's external advisers on the HQJOC Project and the costs Defence advised attached to each of these contracts. Defence advised the ANAO, as part of the agency's response to the proposed audit report, that the costs reported in Table 2.1 include funds allocated during the project's construction phase, in addition to the costs associated with the tender process. Defence letter to the ANAO dated 9 April 2009.

arrangement showed a lower cost to the Government, than the PCB, was the most significant factor in the decision to proceed with a PPP for the Project rather than a direct procurement process.<sup>14</sup>

9. Defence estimated that the NPC of the risk adjusted PCB<sup>15</sup> in April 2006, when the Government agreed to the selection of the eventual Prime Contractor as preferred tenderer, was \$508.1 million. At that time, Defence estimated the NPC of the particular tender response from the Prime Contractor that Defence subsequently entered into a contract for, at \$503.9 million—\$4.2 million less than the risk adjusted PCB. Defence’s estimate of the NPC of the risk adjusted PCB rose between April and June 2006,<sup>16</sup> as did the NPC of the relevant tender response from the Prime Contractor.<sup>17</sup> This resulted in the margin in favour of the Prime Contractor’s relevant tender response as compared to the risk adjusted PCB decreasing to \$0.94 million by 30 June 2006 when Defence signed a legally binding contract with the Prime Contractor for the 30 year PPP.

## Audit approach

10. The objective of the audit was to review Defence’s management of the HQJOC Project’s tender process, including probity management, for the construction of the joint operation headquarters in order to provide assurance that the policy principles for the use of private financing had been followed.<sup>18</sup>

11. The audit examined the pre-construction stage of the Project, which began with a multi-round tender and ended with contract negotiations with

---

<sup>14</sup> Official Committee Hansard, Senate Foreign Affairs, Defence and Trade Legislation Committee, Budget Estimates, Canberra, 1 June 2006, pp. 128–129.

<sup>15</sup> The raw PCB represents the whole of life cost of the ‘benchmark project’. The raw PCB base cost includes all capital, operating and maintenance costs of Defence delivering the requirement, but not risk costs or contingencies often found in traditional budget estimates. The risk adjusted PCB includes in addition the estimated value of those risks that Defence proposes to transfer to the private sector under a private financing arrangement. Under direct procurement, Defence would retain these risks, therefore, their value needs to be estimated and added to the base cost.

<sup>16</sup> The increase in the PCB was due to: an increase in the estimated electricity costs; acceleration costs for the Project to meet the preferred schedule; and additional capital expenditure items.

<sup>17</sup> The increase in the Prime Contractor’s tender response was due to: acceleration costs for the Project to meet the preferred schedule; additional capital expenditure items; and the impact of interest rate rises on the financial model.

<sup>18</sup> The former Department of Finance and Administration issued the *Commonwealth Policy Principles for the Use of Private Financing* in June 2002, which were relevant to the Project at that time. There were three core principles: value for money; transparency; and accountability.



the preferred tenderer and finalisation of the Project's contractual and financial documents.<sup>19</sup> The core period of Project activity covered by the audit extends from April 2004–July 2006, as represented in Figure 1.

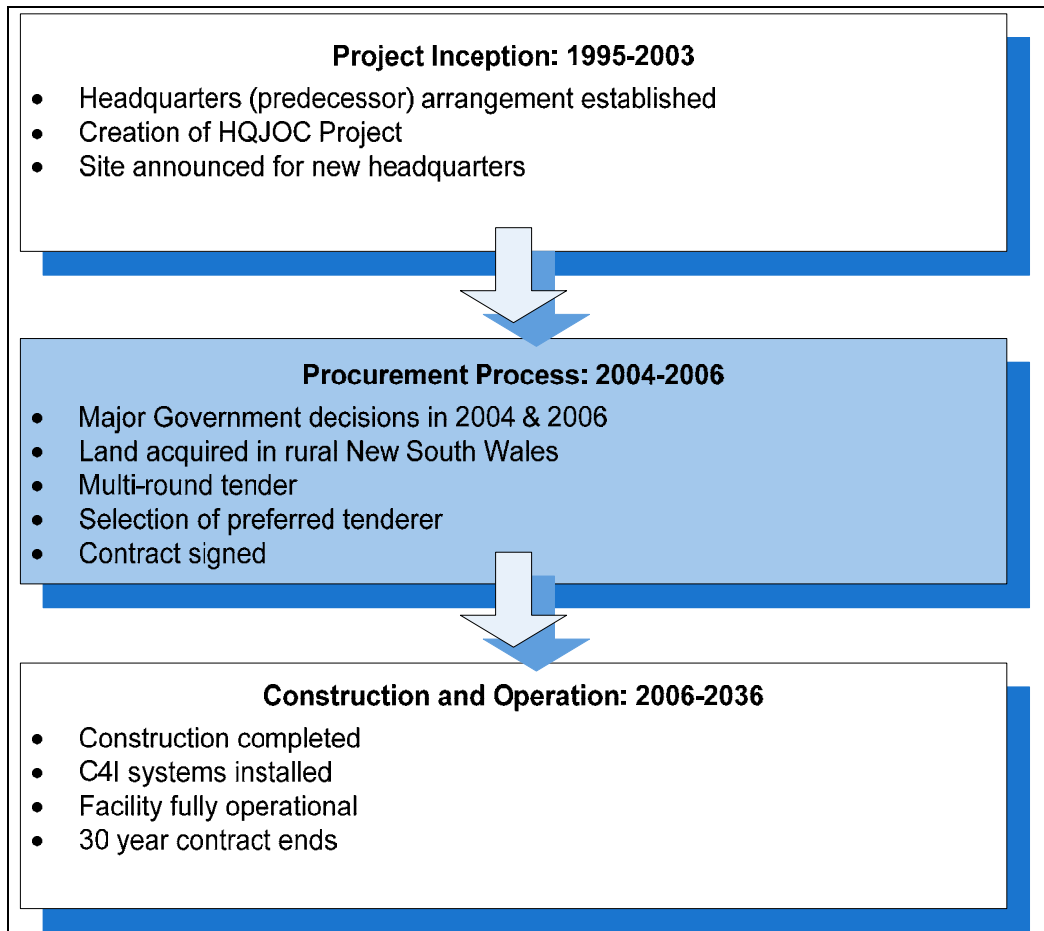
---

<sup>19</sup> The HQJOC Project can be separated into distinct stages as follows:

- Project inception activities;
- a tendering process, to determine the Prime Contractor for the Project;
- construction of the HQJOC facility, by the Prime Contractor;
- installation of the C4I systems, by a separate contractor; and
- post–construction management of the Prime Contractor's delivery of operational services for the facility until the end of the contract term in June 2036.

The audit's scope excluded any consideration of the Project's inception activities and later construction and contract management stages. See Figure 1.

**Figure 1**  
**Audit scope**



Note: This audit of Defence’s management of the tendering process for the construction of the ADF’s HQJOC facility focussed on events during the procurement process, as shown in the blue shaded box.

Source: ANAO analysis.

12. The Australian National Audit Office (ANAO) primarily conducted field work for the audit at the HQJOC Project Office’s workplace in the Australian Capital Territory. The field work involved collecting primary documentary evidence and interviewing senior staff associated with the Project. The audit team interviewed a number of the Project’s key external advisers and the tenderers for the Project. The audit team also undertook a literature review of the available international research on PPPs, which informed the audit’s findings and conclusions.

## Conclusion

13. In June 2006 Defence entered into a 30 year Public Private Partnership (PPP) arrangement for the design, construction, financing, operation and maintenance of a Headquarters Joint Operations Command (HQJOC) facility for the Australian Defence Force (ADF).<sup>20</sup> The contract is scheduled to end in June 2036. In total, Defence determined that the facility will cost \$572.2 million (Net Present Value (NPV) in 2006–07 Budget prices outturned) to build and operate under a 30 year agreement with the private sector.<sup>21</sup>

14. The Project is the first where the Australian Government has used a PPP to both construct and maintain a major facility on a greenfield site. Defence sought the advice of other agencies—Finance, the Treasury, Australian Taxation Office and Australian Government Solicitor—as well as a number of external expert advisers that offered specialist advice to the Project on probity, legal, financial and commercial matters.

## Tender process

15. The then Government determined that Defence's use of a PPP for the Project was conditional on the arrangements achieving superior value for money (VFM), assessed on the basis of cost and risk transfer, compared to the alternative of proceeding using traditional direct procurement for each separate element of the Project. Defence undertook a public tender to evaluate the benefit of using a PPP and determine the Project's Prime Contractor.

---

<sup>20</sup> The Project was to create a new facility to allow the ADF to more effectively plan and conduct its operations and other national and international activities. The new facility replaces existing transitional arrangements and will accommodate approximately 750 members of the ADF and the Australian Public Service in a single location in rural New South Wales.

<sup>21</sup> 'Net Present Value' is the future cash flows, discounted for timing and risk, less the cost of investing in the project calculated in terms of today's worth. Defence announced in 2006 that the nominal whole of life cost for the 30 year project is \$1.2 billion (Goods and Services Tax (GST) exclusive, in 2006–07 Budget prices outturned).

**Table 1**

**Summary of tender rounds and consortia responses after the Request for Tender was issued**

Tender stage	Prime Contractor	Consortium A <sup>A</sup>	Consortium B <sup>B</sup>
Request for Tender	STR <sup>C</sup> ATR1 <sup>D</sup> ATR2 ATR3	STR ATR1 ATR2	STR ATR1
Request for Revised Offer	STR ATR1 ATR2	STR ATR1	STR
Request for Final Revised Offer	STR ATR1 ATR2 ATR3 <sup>E</sup>	Withdrew from the tender at this stage.	STR <sup>F</sup>

Notes: (A) Australian Defence Capability Partnership, later renamed Australian Command Capability Partnership (Bilfinger Berger, Baulderstone Hornibrook, United KG) (referred to as Consortium A in this report).

(B) Synersec (Multiplex Group, Multiplex Infrastructure, Multiplex Constructions, Multiplex Facilities Management, Westpac Banking Corporation) (referred to as Consortium B in this report).

(C) STR: Standard Tender Response. A Standard Tender Response (STR) is defined in the Request for Tender documentation. Key features from the definition are as follows: Each tenderer must submit a STR. A failure by any tenderer to lodge a STR will automatically result in the Commonwealth rejecting all tender responses submitted by that tenderer. STRs should contain a mark-up, where the tenderer considers a mark-up appropriate, of the Part 3 documents. (Part 3 contains the Project Deed, other contractual documents and Schedule 4 of the Project's Output Specification. The preferred tenderer will be expected to enter into a contract with the Commonwealth substantially in the form of the Project Deed.) Any alternative allocation of the risks associated with key contractual provisions of the Project Deed must be presented in an Alternative Tender Response (ATR) and priced accordingly.

(D) ATR: Alternative Tender Response.

(E) All of the tender responses submitted by both remaining tenderers at the Request for Final Revised Offer (RFRO) stage were assessed as compliant with the tender documentation. The Prime Contractor's ATR3 was later set aside from further consideration by the Tender Evaluation Board on the grounds that it was not competitive against the Design and Construction evaluation criteria.

(F) Consortium B referred to two other options in its STR, but did not present the options in any detail or in the form of ATRs. The RFRO Returnable Schedules required that an ATR must be presented to a standard similar to that of a STR and address all of the information requested.

Source: ANAO analysis of Defence documentation.

**16.** To give tenderers guidance as to the Project's scope and affordability, Defence provided them with the department's current estimate of the raw PCB during each of the tender rounds following the issue of the Request for Tender (see Table 2.2). The raw PCB base cost includes all capital, operating and

maintenance costs of Defence delivering the requirement. The risk adjusted PCB (which included cost estimates for the value of those risks that Defence proposed to transfer to the private sector under a private financing arrangement) was not released to the tenderers as it was used by Defence to assist with assessing the overall VFM of the tenderers' responses.

17. The tender process was lengthy and, as shown in Table 1, involved multiple rounds over a two year period because Defence assessed that none of the tenderers' responses to the Request for Tender were compliant and, after issuing a Request for Revised Offer, Defence amended the project's scope so that a fourth and final stage of the tender was required.<sup>22</sup>

18. The major effects from the extended tender process were: increased cost for tenderers to participate; a decrease in the overall number of tender responses in each later round; the withdrawal of one of the tenderers at the final round; and delays to the Project's schedule (approximately 12 months). However, in contrast with general international experience with PPPs, Defence conducted negotiations and reached commercial close (contract signature) with the Prime Contractor one month after the announcement of the Prime Contractor as preferred tenderer, which is a relatively short time for a complex project.

19. Adequate probity management processes for the Project's size and complexity informed Defence's tender process. Even though two significant probity issues arose during the live tender process in 2005—a breach of confidentiality and a breach of the Project's security arrangements—Defence adequately managed its response to both.

---

<sup>22</sup> The four rounds in the tender from April 2004 to April 2006 (selection of a preferred tenderer) were as follows:

- Invitation to Register Interest—issued 2 April 2004 and closed 27 May 2004 (seven responses received and three tenderers were shortlisted for the next round);
- Request for Tender—issued 1 September 2004 and closed 22 February 2005 (three tenderers submitted tender responses);
- Request for Revised Offer—issued 2 May 2005 and closed 3 June 2005 (three tenderers submitted tender responses); and
- Request for Final Revised Offer—issued 24 October 2005 and closed 19 January 2006 (one tenderer subsequently withdrew; only two tenderers submitted final tender responses).

## **Government agreement to the use of a PPP and selection of a preferred tenderer**

20. The Government considered the HQJOC Project in April 2006 and affirmed the use of a PPP for its delivery on the basis of Defence's advice that, based on the evaluation of the tender responses received, a PPP offered better VFM than direct procurement. Defence assessed both of the remaining tenderers (the eventual Prime Contractor and Consortium B) were capable of delivering the HQJOC facility. Three tender responses<sup>23</sup> provided by the Prime Contractor and the sole tender response provided by Consortium B were all assessed by Defence as offering a lower estimated Net Present Cost (NPC) than the estimated whole of life costs of the direct procurement option—as encapsulated in the risk adjusted PCB.<sup>24</sup>

21. At this point, Defence had assessed the NPCs of the Prime Contractor's three competitive tender responses as between \$4.1 million<sup>25</sup> and \$6.8 million<sup>26</sup> lower than the NPC of the risk adjusted PCB. Defence estimated the NPC of Consortium B's tender response to be \$26.1 million lower than the NPC of the risk adjusted PCB. However, Defence advised the Government that, overall, it assessed that the Prime Contractor was closer to accepting the Project's preferred risk allocation, whereby, Defence would transfer suitable project risks to the private sector contractor, as the party best able to manage them. Defence further advised that the price differential between the NPCs of the Prime Contractor's tender responses and Consortium B's tender response would be significantly reduced because of additional risks Defence assessed were associated with Consortium B's tender.<sup>27</sup> Defence ranked Consortium B's tender response last having assessed that it represented the greatest risk due to

---

<sup>23</sup> As can be seen in Table 1, at the Request for Final Revised Offer stage of the tender process, the Prime Contractor submitted a standard tender response and three alternative tender responses (one of which was later set aside from further consideration because it was not competitive against one of the key evaluation criteria).

<sup>24</sup> See footnote 15 for a description of the PCB.

<sup>25</sup> For the Prime Contractor's ATR2.

<sup>26</sup> For the Prime Contractor's STR. The Prime Contractor's ATR1 was estimated to have a margin over the NPC of the risk adjusted PCB of \$4.9 million.

<sup>27</sup> Defence quantified risks related to the need for project acceleration at between \$6.5 million and \$8 million. Defence also identified costs associated with 'risk pushback' to the Commonwealth identified in Consortium B's notations on the Project documentation but concluded that it was not possible to fully quantify such risks in the absence of detailed mark-ups from Consortium B to the Project documentation. See paragraph 3.64.

proposed risk pushback, program risk and uncertainty arising from Consortium B's failure to provide marked-up Project documents<sup>28</sup> with its Request for Final Revised Offer tender response. Defence concluded that the lack of detailed marked-up Project documents would delay contract execution and impact on the delivery schedule if Consortium B was selected as the preferred tenderer.

22. Defence recommended to the Government that the Prime Contractor be selected as the preferred tenderer on the basis of Defence's assessment that the Prime Contractor's tender responses offered the best VFM. Defence ranked the tender responses but did not nominate which of the tender responses provided by the Prime Contractor should be implemented. However, Defence advised the Government that it considered that the Prime Contractor's ATR1 offered the best VFM overall and least risk to the Commonwealth.

23. The material difference between each of the Prime Contractor's three tender responses was the tax model to be applied.<sup>29</sup> In order to be eligible to have ATRs considered, each tenderer was required to submit a compliant STR. Defence had advised tenderers at each stage of the tender process that: 'the Commonwealth will give favourable consideration to bids that are certain and not conditional upon the timing of or enactment of legislation or obtaining favourable tax rulings.'<sup>30</sup> Notwithstanding this advice, the STRs submitted by both Consortium B and the Prime Contractor in the final tender round were based on the assumption that then proposed legislation to introduce a new

---

<sup>28</sup> The key project document was the proposed Project Deed which Defence attached to the RFT and advised tenderers that they would be: 'expected to enter into a contract with the Commonwealth substantially in the form of the Project Deed.' The Prime Contractor provided Defence with marked-up versions of the Project documents which allowed Defence to clearly identify the tenderer's proposed changes and evaluate any possible cost or risk associated with them. By contrast, Consortium B made some notations on the Project documents that Defence assessed as indicating proposed changes that would involve risk pushback to the Commonwealth but, because marked-up copies of the Project documents were not provided by Consortium B, Defence could not quantify the costs attached to the changes Consortium B were seeking. It was not a requirement for tenderers to provide copies of the Project documentation with the specific changes the tenderer would be seeking marked-up on them.

<sup>29</sup> The preferred tenderer's Standard Tender Response (STR) was based on the then proposed Division 250 of the *Income Tax Assessment Act 1997*, its ATR1 was a securitised lease structure and its ATR2 was based on Division 16D of the *Income Tax Assessment Act 1936*, Certain arrangements relating to the use of property.

<sup>30</sup> Returnable Schedule E3, Subcriterion 'Taxation arrangements', Request for Final Revised Offers (RFRO) AZ 3206 (6 December 2005), p. 78.

division of the *Income Tax Assessment Act 1997*, Division 250, would apply to the project.<sup>31</sup>

24. Defence assessed both tenderers' STRs as representing the highest risk to the Commonwealth because of the uncertainty resulting from the tenderers' STRs reliance upon proposed legislation passing the Parliament in time to apply to the Project. This risk eventuated given that the legislation introducing Division 250 was not given royal assent until September 2007, some 14 months after Defence reached financial close with the Prime Contractor in July 2006.<sup>32</sup> The Prime Contractor's STR was ranked above Consortium B's STR on the basis of Defence's assessment of the greater risk related to this tender response (see paragraph 21 and footnote 27).

25. The Government accepted Defence's recommendation that the Prime Contractor be selected as the preferred tenderer with whom Defence would conduct further negotiations. However, notwithstanding Defence's assessment of risk associated with the Prime Contractor's STR, the Government considered that negotiations should proceed with the Prime Contractor on its STR.

26. Although the Government reached this conclusion, it also directed Defence to settle the taxation model to apply to the Project with the Minister for Finance and Administration, the Treasurer and the Minister for Defence. As noted in paragraph 23, the only material difference between the Prime Contractor's three relevant tender responses was the taxation model to be applied.

## **Selection of a tender response**

27. Following the Government's selection of the Prime Contractor as the preferred tenderer, Defence sought advice from the Prime Contractor about implementing its STR, which was the Government's preferred tender response for Defence to conduct negotiations on. The Prime Contractor advised Defence

---

<sup>31</sup> Proposed Division 250, of the *Income Tax Assessment Act (ITAA) 1997*, was to institute arrangements for taxing the proceeds of leases or other arrangements for the use of assets by tax preferred entities, such as the Commonwealth. The *Tax Laws Amendment (2007 Measures No. 5) Act 2007* received Royal Assent on 25 September 2007 and Division 250—Assets put to tax preferred use, was incorporated in the ITAA 1997 and applies to projects after 1 July 2007. Accordingly, the application of Division 250 to projects was not available in April 2006 when Defence sought the Government's agreement to the selection of a preferred tenderer or indeed by the time Defence reached financial close with the Prime Contractor in July 2006.

<sup>32</sup> Under a PPP, the private sector partner's financiers wait until after the commercial close before settling the financial aspects of the transaction. The latter activity is called the financial close.



that, given the uncertain status and timing of the introduction of the proposed new tax legislation, significant time, cost and effort would have been required to structure its STR when it was unlikely that the new legislation would be available to apply to the Project. The Prime Contractor strongly preferred proceeding on the basis of its ATR2 to ensure there was certainty about the tax treatment and outcomes prior to signing a contract for the Project.

28. After seeking advice from the Project's Legal Adviser<sup>33</sup> and officials in Finance and Treasury, and obtaining the agreement of the Project's Governance Board and its then Minister, Defence negotiated with the Prime Contractor on its ATR2. On the basis of the advice received from agencies and the Prime Contractor, Defence subsequently concluded that implementing the Prime Contractor's ATR2 would be VFM and consistent with the Government's decision of April 2006.<sup>34</sup>

29. Defence formally briefed its Minister on several occasions after the Government's April 2006 decision. The Minister for Finance and Administration was also aware of the broad details of Defence's approach to implementing the Government's decision and that officials in Defence, Treasury and Finance had formed a view as to a suitable structure for the Project's tax treatment. However, the Government's decision also required Defence to obtain the formal agreement of the Treasurer to the Project's tax treatment, which was not done. It would also have been prudent for Defence to have provided further advice to the Government about the Project's tender process after April 2006, given the decreasing margin between the Prime Contractor's tender response and the PCB leading up to contract signature (see paragraph 32).

30. The Project's *Process Plan*<sup>35</sup> refers to maintaining competitive tension for the benefit of the Commonwealth during contract negotiation and finalisation. Defence decided that the overall standing of Consortium B's final tender response (its STR) was such that the continuation of negotiations with that tenderer during contract negotiation and finalisation with the preferred

---

<sup>33</sup> Blake Dawson Waldron (now Blake Dawson) were advisers to the HQJOC Project and are referred to in this report as the Legal Adviser.

<sup>34</sup> Defence did not provide further advice to the Government after its April 2006 selection of a preferred tenderer and a preferred tender response (the Prime Contractor's STR).

<sup>35</sup> Australian Government Solicitor, *Headquarters Joint Operations Command Project Process Plan*, 2004, p. 2.

tenderer was not warranted. Nevertheless, Defence retained the ability to negotiate with Consortium B if discussions with the Prime Contractor were unsatisfactory.

### **Narrow margin between PPP and traditional procurement approach**

31. The decision to proceed with the Project using a PPP was not straightforward given the narrow margin associated with Defence's quantitative assessment of VFM using the risk adjusted PCB to compare the tenderers' responses against each other and Defence's direct procurement option.

32. In April 2006, when the Government considered Defence's tender evaluation assessments, the NPC of the Prime Contractor's ATR2 (the tender response later implemented by Defence) was calculated to be \$4.2 million less than the NPC of the risk adjusted PCB. When Defence announced the preferred tenderer in May 2006, following cost increases during clarifying discussions with the Prime Contractor, this margin had reduced to \$1.6 million. By the time Defence concluded its negotiations with the Prime Contractor in June 2006, prior to commercial close (contract signature), the risk adjusted PCB had been revised to \$515.64 million<sup>36</sup> and the estimated NPC of the Prime Contractor's ATR2 was \$514.7 million. Therefore, at the time the final decision was taken by Defence to enter into a PPP arrangement for the Project, Defence estimated that the financial benefit offered to the Commonwealth for doing so compared to using direct procurement was a potential saving in NPC terms of \$0.94 million, or 0.18 per cent, over 30 years.<sup>37</sup>

### **Records management**

33. Construction of the new HQJOC facility began in November 2006; with Defence announcing completion of construction in July 2008. After additional work to install the command, control, communications, computing and

---

<sup>36</sup> An increase of \$19.44 million over the estimation of NPC of the risk adjusted PCB of \$496.2 million, which was provided to the Government in April 2006.

<sup>37</sup> At financial close in July 2006, the private sector partner's financiers completed the financial aspects of the transaction, and the Project's NPV was determined to be \$572.2 million (2006–07 Budget prices outturned). Defence advised the ANAO that the 11 per cent increase in dollar terms between the NPC of \$514.7 million at commercial close, when a legally binding contract was signed, and the NPV at financial close was due to the inclusion in the latter of taxation, insurance and the effect of interest rate changes after the commercial close.

intelligence systems was also completed, the facility was available for full occupation and use by Defence from November 2008. The new facility was officially opened by the Prime Minister, the Hon. Kevin Rudd MP on 7 March 2009.<sup>38</sup> A key determinant of the Project's long-term success will be contract management, which depends, in part, on the Project Office's continuing access to relevant records of the tender and contract negotiation processes.

34. This audit identified that Defence's records dealing with financial matters for the Project may not be sufficiently complete to adequately support future contract management of the annual service payments over the Project's 30 year term. The ANAO encountered difficulty in accessing relevant financial records for the Project. This process, including discussions of financial matters with the Project Office, was protracted. The ANAO identified instances of lack of written records for key decisions and incomplete records.

### Overall conclusion

35. Overall, the ANAO considers that Defence's management of the major elements of the Project's tender process followed the policy principles for the use of private financing established in 2002 in relation to private financing initiatives. Defence pursued an open approach which informed tenderers of the estimated capital, operating and maintenance costs of delivering the Projects' requirements, but did not include cost estimates for the value of those risks that Defence proposed to transfer to the private sector under a private financing arrangement. Additionally, Defence established and followed probity management processes commensurate with the Project's size and complexity.

36. While the use of PPPs is not new in Australia, or overseas, there is continuing debate about the relative merits of the public sector using private financing initiatives to deliver services or infrastructure as an alternative to using traditional direct procurement. The ANAO found that the HQJOC Project was similar to other PPPs in terms of its long-term arrangement with the private sector and complexity, but the tender process was unique because it was the first time Defence, and the Australian Government, had used a PPP

---

<sup>38</sup> The Prime Minister's opening speech is available from [http://www.pm.gov.au/media/Speech/2009/speech\\_0860.cfm](http://www.pm.gov.au/media/Speech/2009/speech_0860.cfm) [accessed 10 March 2009].

to both construct and maintain a major facility on a greenfield site. Defence was supported throughout the Project by Finance and by external advisers that assisted with Defence's assessment of the VFM, viability and risks associated with the tender responses. In the final analysis, the Project involved a costly two year tender process for Defence, and the tenderers, that resulted in a slim final margin of \$0.94 million between the estimated NPC of the risk adjusted PCB and the Prime Contractor's tender response that forms the basis of the facility's 30 year contract.

## Key findings

### Procurement Framework (Chapter 2)

37. The PCB was an essential tool for the Project and central to Defence's assessment of tender responses, the decision to proceed with a PPP and the consequent selection of the Prime Contractor. Defence finalised the risk adjusted PCB in January 2006, for use in evaluating the tenderers' final responses, the day after the tenderers' final responses were received and opened by Defence. This carried risks for the integrity of the tender process. Critical benchmarks such as the PCB should be finalised well in advance of opening the tender responses. This final stage of development of the PCB, relative to the tender process, was not identified as an issue of concern in the probity documents reviewed by the ANAO.

38. A core principle for Australian Government procurement is transparency. Defence has made publicly available a great deal of information about the Project, including the Prime Contractor's details, the timeframe and cost of the Project. However, Defence has not fully complied with the Senate Order for Departmental and Agency Contracts, Annual Report or AusTender requirements for publicly reporting the Project's contracts.<sup>39</sup> The ANAO found no direct correlation between the three reporting mechanisms and no consistent approach by Defence to identifying relevant contracts with the Project.

---

<sup>39</sup> The Senate Order for Departmental and Agency Contracts supports the principles of accountability and transparency in procurement by requiring agencies subject to the *Financial Management and Accountability Act 1997* (FMA 1997) to list certain details within a specified period of time for contracts of \$100 000 or more on the Internet. Defence, as an FMA agency, is required to publish details of all of its consultancies valued at over \$10 000 in its Annual Report. Furthermore, Defence is required by the *Commonwealth Procurement Guidelines* to publish on AusTender contracts and standing offers with a value of \$10 000 or more.

## Tender Process (Chapter 3)

39. Defence took over two years, from April 2004 to June 2006, to complete the Project's tender to the contract signature stage and issued tender documents in four rounds: April 2004, Invitation to Register Interest (ITR) for the Project;<sup>40</sup> September 2004, Request for Tender (RFT); May 2005, Request for Revised Offer; and October 2005, Request for Final Revised Offer.

40. Due to the time required, the inherent complexity of PPPs and Defence's reliance on external expert advice, the tender was conducted at considerable cost to both the private sector consortia tendering and Defence.<sup>41</sup> The total number of tender responses received by Defence reduced after each new tender round and only two of the three original tenderers that were shortlisted after the ITR in April 2004 submitted responses to the final tender round in October 2005. The ANAO encouraged Defence to evaluate its approach to fostering innovative tender responses to RFTs for any future PPPs, which could be of benefit to Defence by reducing the need for additional tender rounds.<sup>42</sup>

41. Defence and the Prime Contractor signed the Project's 30 year contract in June 2006. Based on the planned dates set out in the Project's tender evaluation plans, the actual contract signature date was approximately a year later than originally forecast. Delays in the tender corresponded to an 11 month delay in the completion of the facility to the point where Defence could begin to fully occupy the premises in mid-November 2008.<sup>43</sup>

42. The specific governance and tender evaluation structures established for the Project, including support from external expert advisers and relevant Australian Government agencies, were sufficiently comprehensive to ensure

---

<sup>40</sup> International experience is that the complexity and long timeframes associated with PPP projects mean tendering is expensive and can limit the extent of competition. However, Defence received seven responses to the HQJOC ITR when it was issued in April 2004. Antony Barton, *PFI deals put bidders off*, Supply Management, Volume 12, No.15, 2007, p. 10.

<sup>41</sup> Defence's ten advisers for the Project received a total of some \$15.7 million in payments (see Table 2.1 for details). One of the tenderers advised Defence that it had incurred bid costs in excess of \$4 million leading up to the RFRO stage and expected the final tender stage to add another \$1 million to the cost of tendering for the Project.

<sup>42</sup> Defence was seeking innovative solutions from tenderers to the RFT that would offer better VFM than a prescriptive approach to the Project's Output Specification.

<sup>43</sup> After the building construction was completed and announced by Defence on 11 July 2008, an additional four months was required to install the C4I before Defence could relocate the intended HQJOC staff to the facility. Defence announced the completion of the C4I installation on 14 November 2008.

that the Project was able to comply with the Australian Government's broader procurement framework and Defence's own procurement procedures and guidelines, as outlined in Chapter 2. Defence identified a preferred tenderer in accordance with the Project's stated evaluation criteria, including a quantitative and qualitative assessment of VFM measured against the PCB.<sup>44</sup>

#### **Decision on Preferred Tenderer (Chapter 4)**

43. The possibility of tax benefits is one of the benefits that makes PPPs attractive for private sector investors. It is important for this reason that an individual agency's proposed PPP arrangement considers the potential whole of government implications for tax revenue.<sup>45</sup> The Government specified in its decision in April 2006 the selection of the Prime Contractor as the preferred tenderer for the Project and a requirement that relevant ministers reach agreement on the Project's tax model and settle the financial implications.<sup>46</sup> The Government also selected the Prime Contractor's STR as the preferred tender response for Defence to implement.

44. The tenderers' proposed tax arrangements for the Project became a critical differentiator in the tender's evaluation process as both the Prime Contractor and Consortium B's STRs at the Request for Final Revised Offer stage in January 2006 relied upon a new proposed Division 250 of the *Income Tax Assessment Act 1997*.<sup>47</sup> However, the proposed Division 250 was not enacted at the time Defence evaluated the final tender responses in February 2006 or when the Government selected the Prime Contractor's STR as the preferred tender response in April 2006.

45. Once the tender responses were received, and an approach to the evaluation of the tenderers' tax structures had been settled by the Commercial Tender Evaluation Working Group, this effectively left only the Prime

---

<sup>44</sup> The ANAO did not evaluate the tender responses, but instead analysed key reports from the Tender Evaluation Working Groups and the Source Selection Reports produced by the Tender Evaluation Board.

<sup>45</sup> If the private sector is able to maximise the taxation benefits from a PPP, this could result in the Commonwealth foregoing expected taxation revenue, thus reducing the PPP's VFM on a whole of government basis.

<sup>46</sup> The Ministers for Defence, Finance and Administration and the Treasurer.

<sup>47</sup> The proposed reform was to replace older legislation in the ITAA 1936 with a new Division 250 in the ITAA 1997 in order to improve the tax framework for PPP asset financing arrangements. See footnote 31 for additional detail.

Contractor with viable tender responses that could be entered into by Defence and positively presented to the Government.

46. After the Government's April 2006 decision to select the Prime Contractor as the preferred tenderer and the Prime Contractor's STR as the preferred tender, Defence did not pursue further negotiations with Consortium B due to the overall standing of its final tender response. Defence negotiated and signed a legally binding contract with the Prime Contractor in June 2006, on the basis that the Prime Contractor's ATR2 represented best VFM to the Commonwealth. Defence also considered advice from Treasury officials that implementing ATR2, following discussion with the Prime Contractor, would be consistent with the Government's April 2006 decision to select the Prime Contractor's STR as the preferred tender response. The Project's Legal Process Adviser<sup>48</sup> did not raise any probity concerns about Defence's decision not to negotiate further with Consortium B after the Government's decision.

47. Following the Government's April 2006 decision on the HQJOC Project's preferred tenderer and preferred tender response, there was a clear requirement for Defence to settle the tax model to be used for the Project and the financial implications of that model with its own minister and the Minister for Finance and Administration and the Treasurer. Defence informed the HQJOC Project Governance Board (PGB), and its Minister of the proposed tax treatment for the Prime Contractor's ATR2.<sup>49</sup> The Minister for Finance and Administration was aware that officials in Defence, Treasury and Finance had formed a view as to a suitable structure for the Project's tax treatment. However, the Minister for Defence did not formally settle the Project's tax treatment with the Minister for Finance and Administration and the Treasurer. The Minister for Defence settled the financial implications with the Minister for Finance and Administration as part of meeting the requirements for approval of the Project prior to contract signature.

48. Although, Defence continued to advise its Minister on the Project's progress, the ANAO considered that it would have been beneficial for the PGB

---

<sup>48</sup> Australian Government Solicitor (referred to as the Legal Process Adviser in this report).

<sup>49</sup> Defence established a formal tender evaluation organisation for the Project, commensurate with the Project's complexity, and specified a hierarchy that included evaluation, governance, and decision-making bodies for the Project, which included a Project Governance Board (PGB). Defence advised the PGB in late May 2006 of the outcome of discussions about the Project's tax treatment and Defence's conclusion that the Prime Contractor's ATR2 was considered VFM.

to have also continued its role until Defence finalised all of the Project's contractual matters, which would have been in accordance with the PGB's responsibilities as part of the Project's tender evaluation organisation.<sup>50</sup> A rationale for Defence's downgrading of the PGB's role was not contained in Project Office records. The PGB was established as one of the bodies responsible for overseeing the Project's latter stages. Ordinarily, it would have been expected that such oversight included monitoring Defence's implementation of the Government's April 2006 decision selecting a preferred tenderer for the Project, and subsequent negotiation and finalisation of the contract with the selected preferred tenderer. Because the PGB ceased to have an active role in the latter stages of the Project,<sup>51</sup> it could not effectively monitor the cost increases to the Project as the negotiations proceeded or the reduction in the margin between the Prime Contractor's NPC of delivering the Project compared to the NPC of the PCB.

## **Negotiation and Contract Development (Chapter 5)**

49. The timing of the public announcement of a preferred tenderer for the Project was a significant pressure on Defence in the period immediately after the Government's April 2006 selection of the Prime Contractor as the preferred tenderer. A delay in finalising the public announcement at that stage of the tender would have impacted on Defence's ability to achieve a satisfactory full service commencement date for the new facility and increased the preferred tenderer's bid and therefore the Project's cost.

---

<sup>50</sup> The PGB, as part of the Project's tender evaluation organisation was responsible for the following:

- Oversight of the tender evaluation process.
- Monitoring of the health of the Project to ensure outcomes met Commonwealth and Defence requirements.
- Ensuring the Project's compliance with the *Commonwealth Procurement Guidelines* and the *Defence Procurement Policy Manual*.
- Providing guidance as required to the Tender Evaluation Board on the conduct of the evaluation and the preparation of evaluation reports.

Department of Defence, HQJOC Project Tender Evaluation Plan v3-0, 19 January 2006, p. 10.

<sup>51</sup> The PGB held its final face-to-face meeting in February 2006. Project Office records show that PGB members were contacted again by the Project Office via email in May 2006 and consulted about the Project's tax treatment issue. The Board's Chair and one member's acknowledgement emails, with no substantive comment included, are on Project Office files.



50. As discussed in paragraph 46, Defence did not negotiate further with Consortium B due to the overall standing of that consortium's tender response relative to that of the Prime Contractor. Defence held clarifying discussions with the Prime Contractor on a range of issues during the remaining period of competitive tension before the preferred tenderer was publicly announced in May 2006. The clarifying discussions were to remain confidential and were not to be seen as constituting any legally binding rights in favour of the Prime Contractor or as an intention by Defence to enter into arrangements or contracts with the Prime Contractor.

51. Due to cost increases and scheduling requirements, the difference between the NPC of the Prime Contractor's ATR2 (\$506.5 million) and the NPC of the PCB (\$508.1 million) when Defence announced the preferred tenderer in May 2006 was \$1.6 million, a reduction from \$4.2 million, as it was in April 2006 when the Government selected the preferred tenderer.

52. Defence reached commercial close in June 2006 with the Prime Contractor, one month after the preferred tenderer announcement, which was a relatively short time for a complex project. At commercial close, after various cost increases during the negotiation stage, including rises in interest rates, there was only a 'slim margin' of \$0.94 million remaining between the lower NPC of the Prime Contractor's ATR2 and the NPC of the PCB.<sup>52</sup> In June 2006, Defence was in the position of having no other viable tenderers to negotiate with, and no ability to set aside the process and proceed with direct procurement due to all of the parties' commitment of time and resources up to that point.

53. Defence achieved financial close with the Prime Contractor in late July 2006, one month after commercial close, and completed a small number of matters that were outstanding at financial close after July. The commercial and financial close dates were each one month later than originally planned by Defence during the RFRO stage and approximately a year later than planned at the RFT stage. However, the final stages of the tender were concluded within approximately three months after the Government's decision.

---

<sup>52</sup> The NPC of the PCB for the Commonwealth to directly procure the construction and operation of the HQJOC Project was \$515.64 million, compared with the cost of entering into a PPP with the Prime Contractor to deliver the Project at an NPC of \$514.7 million.

## Payment Schedule (Chapter 6)

54. Defence and the Prime Contractor have estimated the total of the annual service payments required from Defence over the Project's 30 year contract term.<sup>53</sup> The estimate is subject to annual recalculation due to the effect of indexation being applied to the payments.<sup>54</sup> Thus, the Project's final cost is unknown until Defence makes all of the annual service payments and the contract terminates, currently scheduled for June 2036. At the Project's commercial close in June 2006, Defence estimated that the Prime Contractor could deliver the Project at a NPC of \$0.94 million less than the NPC of the PCB.

55. This audit identified that Defence's records dealing with financial matters for the Project may not be sufficiently complete to adequately support management of the annual service payments over the Project's 30 year term. The success of the facility's future contract management depends on the management of those records and the availability of experienced contract managers to administer the next 28 years of payments to the Prime Contractor.<sup>55</sup> The effectiveness of these arrangements will also influence whether or not VFM for the Project is actually realised.

56. The ANAO suggests that there would be benefit for Defence in reviewing the records generated during PPP tender processes to: ensure that all records necessary to inform the future management of the contract have been appropriately collated and stored; and identify how records management arrangements could be strengthened for future PPP tenders.

---

<sup>53</sup> In nominal terms (price of the day), the Project's \$572.2 million NPV is approximately \$1200 million (exclusive of GST). The NPV figure does not include the cost of the separate command, control, communications, computing and intelligence (C4I) systems contract. (The value of the C4I contract was estimated by Defence to be up to \$58.5 million (in 2006–07 Budget prices)).

<sup>54</sup> The annual service payment is indexed on 1 July each year during the term of the agreement according to a formula in the Project Deed. The annual service payment is comprised of two components: capital (non-indexed annual service payment); and operating (includes an indexed annual service payment and a non-indexed annual utilities payment). The capital amount covers the construction capital, finance and taxation costs, while the operating component represents whole of life payments for insurance and operation costs for items such as maintenance and security. The operating component of the payment is further annually adjusted for inflation based on Consumer Price Index figures provided to Defence by Finance.

<sup>55</sup> After the HQJOC Project's contract was signed in 2006, Defence made no payments during the following two year construction period. The first annual service payment is a part year payment in 2008–09, which takes into account that only a small number of the Prime Contractor's staff would be required to support the C4I process from July to November 2008. The first full year payment starts in 2009–10.

## Probity Management (Chapter 7)

57. Probity is an important requirement in any government procurement process and is demonstrated by carrying out procurement in a fair, ethical and transparent manner. Defence established appropriate probity management processes for the Project's size and complexity that were consistent with the probity guidance available for Australian Government procurement.

58. Defence took reasonable steps to ensure that participants in the tender process were aware of the Project's security arrangements, confidentiality requirements and their individual responsibilities. Although, the procedures were not always strictly applied by Defence.

59. Two significant probity issues arose during the tender in late 2005 after the Request for Revised Offer closed in early June 2005 and before Defence issued the Request for Final Revised Offer in late October 2005—a breach of confidentiality and a breach of security.

60. Defence's actions in response to the breach of confidentiality were in accordance with the requirements of the HQJOC Project's *Process Plan* and records maintained by Defence indicate that no tenderer was disadvantaged by the breach of confidentiality that took place during the live tender for the Project. However, by failing to notify the Project's Legal Process Adviser of the security breach, Defence did not act in accordance with the Project's probity management process for that matter. Additionally, Defence's records for the security breach investigation are incomplete and do not clearly document the process followed and may not be a complete record of all of the remedial steps taken by the Project Office after the investigation ended. The available records would make it difficult for Defence to draw any lessons learned from the handling of this matter for application to similar procurement processes in the future.

61. Defence advised the ANAO, as part of the agency's response to the proposed audit report, that: 'Lessons were learnt on the conduct of procurement evaluation activities from this incident and will be included in future PPP projects'.<sup>56</sup>

62. The ANAO noted that the Project received final probity sign-off and risk audit reports from the Project's Legal Process and Risk Management

---

<sup>56</sup> Defence letter to the ANAO dated 9 April 2009.

Advisers that, overall, were not critical of Defence's handling of probity issues.<sup>57</sup> However, the Legal Process Adviser was not aware of the breach of the Project's security arrangements and the scope of the Risk Management Adviser's engagement specifically excluded a detailed audit of the Project's security arrangements because of an earlier investigation by Defence's then Inspector-General's audit team of the Project's breach of security.

63. All three of the consortia tendering for the Project, at the time the two significant probity issues arose during the live tender, later indicated to Defence that they were satisfied with Defence's response to the issues. Therefore, while Defence did not effectively address some elements of the management of the two significant probity issues that arose, no adverse consequences for the tender were recorded by Defence.

## Responses to the proposed report

### Department of Defence

64. The Headquarters Joint Operations Command (HQJOC) Project is the first Public Private Partnership (PPP) by the Australian Government for the construction and maintenance of a facility on a greenfield site. The project was complex, incorporating both PPP project delivery and a direct procurement for the Command, Control, Communication, Computing and Intelligence (C4I) systems. Notwithstanding the complexity of the project, it was delivered successfully on time and on budget.

65. Defence welcomes the Australian National Audit Office (ANAO) report on *Management of the Tendering Process for the Construction of the Joint Operation Headquarters*. Defence is addressing the issues raised in the report and has established a PPP Branch and the National Contract Administration and Management Directorate in order to improve the management and delivery of future PPP projects. Defence notes that the report does not make any significant adverse findings and does not contain any formal recommendations.

66. Defence's detailed comments are contained in Appendix 1.

---

<sup>57</sup> Capital Insight Pty Ltd (referred to as the Risk Management Adviser in this report).

## **Other responses**

67. The proposed report was sent to a number of other Australian Government agencies and organisations (see paragraph 1.22). The Prime Contractor provided comments for inclusion in the final report and these are contained in Appendix 2.



# **Audit Findings and Conclusions**





# 1. Introduction

---

*This chapter describes the Department of Defence's Headquarters Joint Operations Command Project and explains the audit approach and the structure of the report.*

## Background

**1.1** The Department of Defence (Defence), within the Defence portfolio, is responsible for the Headquarters Joint Operations Command (HQJOC) Project.<sup>58</sup> The HQJOC Project is to create a new operational military headquarters for the Australian Defence Force (ADF) that will replace transitional facilities and staffing arrangements with a single purpose-built facility.<sup>59</sup>

**1.2** The operational level of command is positioned between the strategic and tactical levels in the command structure of the ADF. Defence commissioned the building of a new facility in order to more effectively plan and conduct ADF operations, and other activities such as support for national and international disaster relief. The new facility will also support Australia's participation in large-scale allied military operations in countries such as Afghanistan.

---

<sup>58</sup> The Defence portfolio includes the Defence Materiel Organisation and the Department of Veterans' Affairs. The HQJOC Project was formerly known as the Headquarters Australian Theatre Project (HQAST).

<sup>59</sup> The ADF is also within the Defence portfolio and comprises members of the Navy, Army and Air Force Services. The HQJOC Project will locate in one facility the operational command and supporting elements of the following units:

- Headquarters Joint Operations Command, Maritime Command and Joint Operations Intelligence Centre Australia, Potts Point, Sydney, New South Wales;
- Air Command, Glenbrook, Lower Blue Mountains, New South Wales;
- Land Command, Victoria Barracks, Sydney;
- Joint Logistics Command, Victoria Barracks, Melbourne, Victoria;
- Special Operations Command, Sydney and Canberra, Australian Capital Territory;
- Headquarters 1st Joint Movement Group, Central Business District, Sydney; and
- National Welfare Coordination Centre, Randwick, Sydney.

As part of the transitional arrangements for the relocation to the new facility, some elements of these organisations have already relocated to Canberra (Defence Establishment Fairbairn and Russell Offices).

**1.3** The HQJOC facility has been constructed on what was a greenfield rural site owned by the Australian Government and located between Queanbeyan and Bungendore in southern New South Wales.<sup>60</sup> The Commonwealth purchased the land, but the buildings, infrastructure and services components are being delivered via a Public Private Partnership (PPP).<sup>61</sup> The Government announced in May 2006 that a private sector company Praeco Pty Limited (the Prime Contractor) was the preferred tenderer for the Project.<sup>62</sup> Defence signed a contract with the Prime Contractor on 30 June 2006 for delivery and operation of the HQJOC facility for 30 years from June 2006–June 2036. Ownership of the facility transfers to Defence at the end of the contract’s 30 year term.<sup>63</sup>

**1.4** In total, the financial modelling for the Project, completed on 28 July 2006, determined that the whole of life Net Present Value (NPV) of the private sector consortium providing the buildings, infrastructure and services over the Project’s 30 year term was \$572.2 million (2006–07 Budget prices, outturned).<sup>64</sup> The contract comprises a fixed value capital component and an operating component, part of which is subject to indexation.<sup>65</sup>

**1.5** In addition, Defence directly contracted with ADI Limited (trading as Thales Australia) to deliver the Project’s command, control, communications,

---

<sup>60</sup> ‘Greenfield’ is a term used to describe undeveloped land.

<sup>61</sup> The Australian Government defines PPPs as:

a form of government procurement involving the use of private sector capital to wholly or partly fund an asset—that would have otherwise been purchased directly by the government—which is used to deliver Australian Government outcomes.

Department of Finance and Deregulation, *Australian Government Policy Principles for the Use of Public Private Partnerships - FMG 21* [Internet]. Department of Finance and Deregulation, Canberra, 2006, available from <<http://www.finance.gov.au>> [accessed 27 June 2008].

<sup>62</sup> The Prime Contractor is a specific purpose company jointly owned by Leighton Contractors and ABN AMRO (equal fifty per cent shareholders) operating as a consortium. Leighton Contractors will construct the Project’s facilities and Spotless Services Australia will provide facilities management services, including maintenance.

<sup>63</sup> Under the Accounting Standard AASB 117 ‘Leases’, the Project is classified as a finance lease.

<sup>64</sup> ‘Net Present Value’ (NPV) is the future cash flows, discounted for timing and risk, less the cost of investing in the project calculated in terms of today’s worth. Outturned prices are estimates adjusted to incorporate the expected rate of inflation. Defence announced in 2006 that the nominal whole of life cost for the 30 year project is \$1200 million (Goods and Services Tax (GST) exclusive, in 2006–07 Budget prices outturned).

<sup>65</sup> The operating component includes an indexed annual service payment and a non-indexed annual utilities payment (see Chapter 6 for details of the annual service payment).

computing and intelligence systems (C4I). The value of that contract was estimated by Defence to be up to \$58.5 million (in 2006–07 Budget prices).<sup>66</sup> Construction of the new HQJOC facility began in November 2006. Defence announced the completion of the facility’s construction on 11 July 2008, after which the C4I systems were installed. The facility was available for full occupation and use by Defence from 14 November 2008<sup>67</sup> and was officially opened on 7 March 2009.<sup>68</sup>

## Project inception

1.6 Table 1.1 sets out in summary form the key dates and events surrounding the inception of the Project.

**Table 1.1**

### HQJOC Project: key dates and events at inception

Key date	Event
December 1995	As a result of changes to ADF command arrangements: <ul style="list-style-type: none"> <li>• Headquarters Australian Theatre (HCAST)—predecessor to HQJOC—established; and</li> <li>• Commander Australian Theatre appointed.</li> </ul>
January 1996	Interim HCAST facility established at a Defence site in Sydney (but some staff remained in other locations in Sydney and Melbourne).  HQJOC Project established to determine a permanent location.
December 2000	The Government endorsed the establishment of a single collocated theatre headquarters in a White Paper, <i>Defence 2000: Our Future Defence Force</i> .
October 2001	The Prime Minister announced the site in New South Wales for the new headquarters.

<sup>66</sup> Prices are exclusive of GST. The total capital cost of the HQJOC Project is \$339.2 million (in 2006–07 Budget prices) with major expenditure of \$250.8 million for the buildings and infrastructure, up to \$58.5 million for the C4I, and the remaining amount (approximately \$29.9 million) was used for acquiring the land for the site and other Project elements, for example, workplace relocation costs, design and professional fees.

<sup>67</sup> Parliamentary Secretary for Defence Support, the Hon. Dr Mike Kelly MP, Media Release *Headquarters Joint Operations Command Project – Facilities Handover* [Internet]. Department of Defence, Canberra, 14 November 2008, available from <<http://www.defence.gov.au>> [accessed 14 November 2008].

<sup>68</sup> The HQJOC facility was officially opened by the Prime Minister, the Hon. Kevin Rudd MP on 7 March 2009. The Prime Minister’s opening speech is available from <[http://www.pm.gov.au/media/Speech/2009/speech\\_0860.cfm](http://www.pm.gov.au/media/Speech/2009/speech_0860.cfm)> [accessed 10 March 2009].

Key date	Event
November 2003	Defence prepared an Acquisition Business Case for a Collocated Headquarters Australian Theatre Project.
March 2004	<p>The Government approved Defence inviting tenders for the delivery of the building and infrastructure components of HQAST.</p> <p>Following a review process in Defence, the Minister for Defence announced new ADF command arrangements.<sup>69</sup></p> <ul style="list-style-type: none"> <li>• establishment of a Joint Operations Command; and</li> <li>• operational command of the ADF to be executed through the Vice Chief of the Defence Force, as Chief of Joint Operations.<sup>A</sup></li> </ul> <p>The House of Representatives referred the HQJOC Project to the Parliamentary Standing Committee on Public Works (PWC) for consideration and report.<sup>B</sup></p> <p>Defence issued an Invitation to Register interest for the Project in April 2004, followed by a Request for Tender in September 2004.</p>
August 2004	The PWC reported on the HQJOC Project and recommended that the Project proceed. Parliament approved the recommendation.
March 2005	Commonwealth acquired the land for the HQJOC site via compulsory acquisition.

Notes: (A) HQJOC is the operational military headquarters for the Chief of Joint Operations. The Chief of Joint Operations is responsible to the Chief of the Defence Force. Deputy Chief of Joint Operations, formerly Commander Australian Theatre, supports the Chief of Joint Operations.

(B) Under the *Public Works Committee Act (1969)* any public work (on a capital asset) for an Australian Government agency or department estimated to cost more than the threshold amount of \$15 million is required to be referred to the PWC.

Source: ANAO analysis.

**1.7** After initial consideration by the Parliamentary Standing Committee on Public Works (PWC) in March 2004, as shown in Table 1.1, Defence was also required to advise the Committee of any significant changes to the Project.<sup>70</sup> ANAO Audit Report No.28 2007–08, *Defence's Compliance with the Public Works Committee Approval Processes*, noted that Defence did not notify the Committee in 2005 of a reduction in the staffing requirement for the Project from 1185 to

<sup>69</sup> Senator Robert Hill, was the Minister for Defence from November 2001 to January 2006. Senator Hill was replaced by Dr Brendan Nelson MP, who occupied the position of Minister for Defence from January 2006 until a Federal election in November 2007.

<sup>70</sup> The requirement to notify the PWC of any significant changes to projects, whether financed through direct procurement or a PPP, is contained in the PWC *Manual of Procedures for Departments and Agencies*. ANAO Audit Report No.28 2007–08, *Defence's Compliance with the Public Works Committee Approval Processes*, paragraphs 1.10–1.11, pp. 21–23 and paragraph 3.35, p. 48.

750 staff (see Chapter 3, for details of the change). Defence briefed the Committee about the change in October 2006.<sup>71</sup>

1.8 Defence advised the ANAO, as part of the agency's response to the proposed audit report, that the PWC was briefed by Defence in October 2006 when the tendering process had been completed and: 'This ensured there were no probity related matters, thereby minimising risk during the tendering phase. The briefing to the PWC in October 2006 met the PWC's recommendations'.<sup>72</sup>

## Project objective

1.9 Defence identified a number of key objectives for the Project and they are set out in Figure 1.1.

### Figure 1.1

#### Key objectives for the HQJOC Project

The HQJOC Project's key objectives are to:

- enhance command and control arrangements by ensuring that all commanders, their specialist advisers and staff, and applicable agencies are proximate to the Chief of Joint Operations;
- ensure a more effective allocation of resources and improved information flow through Defence to Government with more informed and responsive advice;
- provide a modern, secure and flexible working environment able to sustain demanding, and at times, intense operations;
- provide C4I systems architecture that supports these capabilities, yet is flexible, and will accommodate technological change;
- offer advantages in terms of back-to-back postings of Canberra-based staff and their families;
- achieve commissioning and handover of the Headquarters complex within the timeframes proposed; and
- achieve energy efficiency and provision of environmentally and ecologically sustainable services for the Headquarters complex.<sup>A</sup>

Note: (A) Defence also pursued biophysical (physical environment) and socio cultural (community and economic) objectives for the Project.

Source: Australian Government Solicitor, *Headquarters Joint Operations Command Project Process Plan*, 2004, pp. 1–2.

<sup>71</sup> *ibid.*, paragraphs 3.35–3.36, pp. 48–49.

<sup>72</sup> Defence letter to the ANAO dated 9 April 2009.

## Project elements

**1.10** The Project has proceeded with Defence using a PPP for the design, construction, financing, facilities operation and maintenance of the headquarters complex. After identifying that private financing for the C4I systems would not provide value for money (VFM), and would reduce operational flexibility for Defence because of the difficulty in integrating a privately financed command and control system with Defence's command and control network, Defence proceeded to procure the C4I for the facility using direct procurement, as described in paragraph 1.5.<sup>73</sup>

## Public Private Partnerships

**1.11** PPPs are commonly used by many governments for substantial infrastructure projects. In 2006 the Department of Finance and Deregulation (Finance) considered that projects with a whole of life cost over \$100 million are more suitable for PPPs than projects of lesser value.<sup>74</sup> Benefits for the public sector arising from the use of PPPs include access to specialist expertise, the potential for innovation and the ability to transfer risk.

**1.12** The use of PPPs is comparatively rare in Defence: 'three out of 22 Defence [facilities and infrastructure] projects referred to the [PWC] between mid-2004 to mid-2007 have been or are expected to be financed in this way'.<sup>75</sup> The HQJOC Project is the first project where the Australian Government has used a PPP to both construct and maintain a major facility on a greenfield site.<sup>76</sup> Defence moved to establish a Public Private Partnerships Branch in the

---

<sup>73</sup> Department of Defence, *Acquisition Business Case-Collocated Headquarters Australian Theatre Project*, November 2003, p. 9.

<sup>74</sup> Department of Finance and Deregulation, op. cit., p. 4. In December 2008, Infrastructure Australia published *National Public Private Partnership Guidelines*. A component of the guidelines, *Volume 1: Procurement Options Analysis*, notes that: 'Projects with a total capital value exceeding \$50 million have the potential to result in value for money through PPP delivery', p. 6. The *Infrastructure Australia Act 2008* sets out the functions of Infrastructure Australia, including its primary function of providing advice to the Minister, Commonwealth, State, Territory and local governments, investors in infrastructure and owners of infrastructure on matters relating to infrastructure.

<sup>75</sup> The three capital works PPP projects referred to are the: HQJOC Project; Single Living Environment and Accommodation Precinct (LEAP) Phase 1 project; and, the Single LEAP Phase 2 project. Australian National Audit Office, op. cit., paragraph 2.20, p. 33.

<sup>76</sup> In Australia, State governments have used PPPs for roads, tunnels, hospitals, prisons and schools. Other examples from overseas include waste facilities, construction of government offices, train infrastructure, defence facilities and airports. International Federation of Accountants, *Service Concessions / PPPs*, IFAC, Montreal, 2007, pp. 20-21.

Defence Support Group (DSG) in July 2008 to undertake PPP projects for Defence. Defence advised the ANAO of the following:

Initially the Branch will be focussed on completing the HQJOC and Single LEAP (Living Environment and Accommodation Precinct) Phase 1 contract requirements and then transitioning the contract administration and support within DSG.<sup>77</sup> Single LEAP is a Defence project to bring living-in accommodation, for single members of the ADF into line with community standards. The Branch is structured to produce PPP Policy developed from Government Guidelines and lessons learnt on Projects.<sup>78</sup>

**1.13** It is also noteworthy that one of the terms of reference for the *Defence Procurement and Sustainment Review* (2008) was to examine the potential for also using PPPs for defence material procurement and sustainment.<sup>79</sup> The review's report, *Going to the Next Level*, September 2008, made two recommendations about the potential future use of PPPs by the Defence Materiel Organisation (DMO) for procurement and sustainment activities.<sup>80</sup>

**1.14** As is the case for direct procurement, VFM underpins the use of PPPs by the public sector. When the Government gave an approval in March 2004 for Defence to proceed with the HQJOC Project as a PPP, it was conditional on the arrangements achieving superior VFM compared to the alternative of direct procurement.

**1.15** Figure 1.2 shows the advantages Defence identified from delivering the Project as a PPP.

---

<sup>77</sup> See <<http://www.defence.gov.au/id/sla/default.htm>> for details of Defence's Single LEAP Project.

<sup>78</sup> Email from the Director General, HQJOC Project and Public Private Partnerships Branch, Defence, to the ANAO dated 28 November 2008.

<sup>79</sup> Parliamentary Secretary for Defence Procurement, the Hon. Greg Combet MP, Media Release *Defence Procurement and Sustainment Review* [Internet]. Department of Defence, Canberra, 7 May 2008, available from <<http://www.minister.defence.gov.au>> [accessed 19 June 2008].

<sup>80</sup> Department of Defence, *Going to the Next Level. The report of the Defence Procurement and Sustainment Review*, Defence, Canberra, 2008, p. 40. The ANAO notes that in its response to this report, issued on 2 May 2009, Defence agrees to the two PPP recommendations.

## Figure 1.2

### Defence's perspective: advantages of a PPP for the HQJOC Project

Defence identified the following advantages from delivering the HQJOC Project as a PPP:

- cost-effective allocation of many of the risks inherent in the Project's delivery;
- adopting a whole of life approach through the integration of design and construction with operations and maintenance;
- certainty of cost for a defined scope and sustained quality service delivery; and
- improved financial management and accountability on a whole of life basis.<sup>81</sup>

Source: Department of Defence.

**1.16** The ANAO noted that in Defence's 2003 *Acquisition Business Case* for the HQJOC Project the proposed process, and therefore schedules, are the same through the Government approvals phase of the Project for a PPP and direct procurement, but differ in the tendering phase. The PPP schedule was noticeably longer with the inclusion of a financial close process, which is not required for a direct procurement.<sup>82</sup> Defence suggested that the schedule difference was most likely due to the inherent complexity of PPPs and the Department's limited experience using the approach. In the delivery schedule, the estimated full completion and occupancy date was also later for the PPP option, due to a different schedule for construction and subsequent installation of the C4I systems.

## Audit objective and approach

**1.17** The objective of the audit was to review Defence's management of the HQJOC Project's tender process, including probity management, for the construction of the joint operation headquarters in order to provide assurance that the policy principles for the use of private financing had been followed.<sup>83</sup>

---

<sup>81</sup> Department of Defence, *Headquarters Joint Operations Command Project – Frequently Asked Questions* [Internet]. Department of Defence, Canberra, 2007, available from <<http://www.defence.gov.au/id/hqjoc/default.htm>> [accessed 26 June 2008].

<sup>82</sup> Under a PPP, financial close occurs when the private sector partner's financiers conclude the financial aspects of the transaction.

<sup>83</sup> The *Commonwealth Policy Principles for the Use of Private Financing* were issued by Finance in June 2002 and contain three core principles:

- value for money;
- transparency; and
- accountability.

Footnote continued on the next page...



**1.18** As described in paragraph 1.10, there are two separate elements to the Project. The approach for this audit was to focus on the PPP component of the Project because it was the first time Defence had engaged in such a partnership after Finance issued the *Commonwealth Policy Principles for the Use of Private Financing* in June 2002.<sup>84</sup>

**1.19** The Project has a number of distinct stages. This audit examined the pre-construction stage, beginning with a multi-round procurement process and ending with contract negotiations with the preferred tenderer and finalisation of the Project's contractual and financial documents.<sup>85</sup> The core period of Project activity covered by the audit extends from April 2004–July 2006.

**1.20** The audit's scope excluded any consideration of the later construction (including C4I installation) and contract management stages of the Project. An assessment of the Project Office's financial management activities for the period, such as the operation of specific cost centres and the administration of payments to the Project's advisers, was also outside the audit's scope.

**1.21** The ANAO conducted field work for the audit between May 2007 and February 2008, mainly at the HQJOC Project Office's workplace in the Australian Capital Territory.<sup>86</sup> The field work involved collecting documentary evidence and interviewing senior staff associated with the Project. The audit

Finance provides PPP guidance and support to Australian Government agencies. Finance published a new version of the Policy Principles document titled *Australian Government Policy Principles for the Use of Public Private Partnerships*, Financial Management Guidance No. 21, in December 2006. This publication was not available to the HQJOC Project Office for the phase of the HQJOC Project examined in this audit, however, the earlier 2002 advice is consistent with the current 2006 guidance.

<sup>84</sup> At the time the *Commonwealth Policy Principles for the Use of Private Financing* advice was issued in June 2002, the full name of the department was the Department of Finance and Administration. Following changes to the Administrative Arrangements Order on 25 January 2008 the agency became the Department of Finance and Deregulation.

<sup>85</sup> The Project can be separated into distinct stages as follows:

- Project inception activities;
- a tendering process, to determine the Prime Contractor for the Project;
- construction of the facility, by the Prime Contractor;
- installation of the C4I systems, by a separate contractor; and
- post-construction management of the Prime Contractor's delivery of operational services for the facility until the end of the contract term in June 2036.

<sup>86</sup> The ANAO met with Defence and relevant former advisers to the HQJOC Project to discuss the key financial matters (including the Project's financial model) that were central to the audit. A total of three face to face meetings were held in August 2007, October 2007 and February 2008.

team interviewed a number of the Project's key external advisers and the tenderers for the Project. The audit team also undertook a literature review of the available international research on PPPs, which informed the audit's findings and conclusions. This audit was conducted in accordance with ANAO auditing standards at a cost to the ANAO of \$470 000.

**1.22** The audit's proposed report, or a relevant extract, was sent to the following Australian Government agencies and organisations for comment:

- Department of Defence;
- Department of Finance and Deregulation;
- The Treasury;
- Australian Government Solicitor;
- the Prime Contractor (Praeco Pty Limited), Consortium A and Consortium B; and
- a number of Defence's external project advisers.

## Report structure

**1.23** Following this introductory chapter, the remainder of the report is presented in six chapters:

- Chapter 2: Procurement Framework;
- Chapter 3: Tender Process;
- Chapter 4: Decision on Preferred Tenderer;
- Chapter 5: Negotiation and Contract Development;
- Chapter 6: Payment Schedule; and
- Chapter 7: Probity Management.

## 2. Procurement Framework

---

This chapter describes the procurement framework for the HQJOC Project, including the role of external advisers to the Project, and discusses the development of a public sector comparator.

### Introduction

**2.1** In this chapter, the ANAO considered the HQJOC tender in terms of the requirements of the broader government procurement framework by focussing on two of the three core principles contained in the *Commonwealth Policy Principles for the Use of Private Financing*.<sup>87</sup> The three core principles are:

- VFM (underpins all Australian Government procurement);<sup>88</sup>
- transparency; and
- accountability.<sup>89</sup>

**2.2** This chapter also discusses the development of a public sector comparator, as a central evaluation tool for use with PPPs, and the role of external advisers to the Project.

### Government procurement framework

**2.3** Australian Government agencies are required to comply with relevant legislation and policy or guidance material when undertaking procurement. In addition, each agency has specific internal procedures or operational guidelines for how to conduct procurement.<sup>90</sup>

---

<sup>87</sup> Finance released an updated version of this publication in December 2006 with the same core principles. However, the ANAO's analysis is based on the earlier 2002 version, which was available to the Project Office at the time of the tender process.

<sup>88</sup> The core principle of 'value for money' for the HQJOC Project is analysed in detail in Chapter 3.

<sup>89</sup> Department of Finance and Administration, *Commonwealth Policy Principles for the Use of Private Financing*, Finance, Canberra, 2002, p. 7.

<sup>90</sup> These generally include specific instructions on procurement included in the agency's Chief Executive Instructions issued under the *Financial Management and Accountability Act 1997* (see paragraph 2.7).

## Financial legislative framework

2.4 The *Financial Management and Accountability Act 1997* (FMA Act) establishes the legislative framework for the operation of financial administration in Defence, including for procurement. The FMA Act operates in conjunction with two pieces of subordinate legislation: the *Financial Management and Accountability Regulations 1997* (FMA Regulations); and *Financial Management and Accountability Orders* (FMA Orders).<sup>91</sup>

## Procurement policy framework

2.5 The Government's procurement policy framework is comprised of:

- the *Commonwealth Procurement Guidelines*, issued by the Finance Minister (under regulation 7 of the FMA Regulations), which establish the procurement policy framework for agencies;
- Finance Circulars, issued by Finance, which advise of key changes and developments in the Government's procurement policy framework; and
- a range of web-based and printed guidance documents, developed by Finance to assist agencies and officials to implement the Government's procurement policy.<sup>92</sup>

2.6 Defence, as a department subject to the FMA Act, is to have regard to the current version of the *Commonwealth Procurement Guidelines* (CPGs) when performing duties related to procurement.<sup>93</sup> The *Commonwealth Policy Principles for the Use of Private Financing* (2002), also produced by Finance, expand the advice for agencies contained in the Government's procurement policy framework.<sup>94</sup>

---

<sup>91</sup> Department of Defence, Chief Executive Instructions, Role and Purpose, July 2004, p. 1.

<sup>92</sup> Department of Finance and Administration, *Commonwealth Procurement Guidelines* Financial Management Guidance No.1, Finance, Canberra, 2005, p. 3.

<sup>93</sup> *ibid.*, p. 2. Mid-way through the HQJOC tender process the 2001 version of the CPGs was revised and a new version issued in 2005.

<sup>94</sup> As described in footnote 83, Finance provides PPP guidance and support to Australian Government agencies. Finance published a new version of the Policy Principles document titled *Australian Government Policy Principles for the Use of Public Private Partnerships*, Financial Management Guidance No. 21, in December 2006. This publication was not available to the HQJOC Project Office for the phase of the HQJOC Project examined in this audit, however, the earlier 2002 advice is consistent with the current 2006 guidance.

## Defence's procurement procedures and guidelines

2.7 Defence's Chief Executive Instructions (CEIs) set out both policy and operational guidelines that all Defence officials are required to comply with. The CEIs issued by the Secretary, or the Secretary's delegate, are based on powers derived from the financial legislative framework described in paragraph 2.4.<sup>95</sup>

2.8 CEI 2.1, 'Procurement of Goods and Services', outlines the broad framework, principles and procedures for procurement that apply in Defence. In particular, officials undertaking procurement activities: 'must have regard to the CPGs, the *Defence Procurement Policy Manual* (DPPM) and other Defence policy material'.<sup>96</sup> The DPPM—the primary reference document for all Defence procurement, maintained by DMO—incorporates the CPGs and includes specific guidance on the 'Private Financing Procurement Process'. Additional guidance for officials in the HQJOC Project Office was also available in Defence's *Private Financing Manual* (2002).

2.9 The Project was required to comply with the Government's procurement policy framework and Defence's procurement procedures and guidelines in order to achieve VFM and maintain the principles of transparency and accountability.

## Accountability and transparency: reporting on contracts

2.10 Defence appointed ten advisers to assist with the Project's specialist requirements, for example, an Environmental Consultant and a Financial and Commercial Adviser. Because external advisers were appointed to the Project (at a total cost of some \$15.7 million), there was a requirement for Defence to comply with a number of public reporting requirements, which are discussed in the following sections.

### External project advisers

2.11 The scope of the Project and its delivery as a PPP was a new experience for Defence. The ANAO's research of the international literature on PPPs found that the inherent complexity associated with PPPs can create higher

<sup>95</sup> Department of Defence, op. cit., p. 1. Defence advised the ANAO in October 2008 that it was revising the CEIs and also developing a complementary Financial Management Manual (FINMAN 5) to assist its officials with meeting the requirements of each CEI.

<sup>96</sup> *ibid.*, p. 2.

costs (for both the public and private sector) through the employment of legal and financial advisers to help understand and interpret the detail of the arrangements.<sup>97</sup>

**2.12** Thus, Defence could not reasonably have been expected to have available staff suitably experienced with PPPs and able to perform the complex financial modelling required. In addition to seeking advice from Finance generally about the development of a PPP for the Project, and specifically in developing the PCB, Defence appointed a number of specialist advisers to assist with the Project.

**2.13** Table 2.1 lists the Project’s advisers, their role and Defence’s expenditure. This audit reviewed Defence’s management of the tendering process for the construction of the HQJOC facility from April 2004–July 2006. However, for completeness, Defence provided a full list of the cost of the Project’s external advisers for the tender phase as at 30 June 2007.<sup>98</sup>

**Table 2.1**

**Cost of external HQJOC Project advisers**

Adviser role	Contractor	Contract cost (\$ as at 30 June 2007, GST exclusive <sup>^</sup> )
Architectural Adviser	Bill Szydluk Architects	43 641
C4I Adviser <sup>B</sup>	Codarra Advanced Systems Pty Ltd	3 604 881
Cost Planning Adviser	Property Concept and Management Pty Ltd	42 372
Environmental Impact Statement Consultant	URS Australia Pty Ltd	1 862 349
Financial and Commercial Adviser <sup>C</sup>	Macquarie Bank Pty Ltd Deloitte Touche Tohmatsu	1 031 240 413 565
Legal Adviser	The then Blake Dawson Waldron. (The firm changed its name to Blake Dawson in November 2007.)	2 452 611
Legal Process Adviser <sup>D</sup>	Australian Government Solicitor	1 246 652

<sup>97</sup> Association of Chartered Certified Accountants, *Evaluating the Operation of PFI in Roads and Hospitals*, Research Report No. 84, ACCA, London, 2004, pp. 64–65.

<sup>98</sup> Financial close for the HQJOC Project was not achieved until 28 July 2006, that is, in the 2006–07 financial year.

Adviser role	Contractor	Contract cost (\$ as at 30 June 2007, GST exclusive <sup>A</sup> )
Output Specification Adviser	Connell Wagner Pty Ltd	2 279 424
Project Consultant	APP Corporation Pty Ltd	2 148 529
Risk Management Adviser	Capital Insight Pty Ltd	573 564
<b>TOTAL</b>		<b>15 698 827</b>

Notes: (A) Costs rounded to the nearest dollar and so may not add precisely.

(B) Even though the C4I systems—command, control, communications, computing and intelligence systems—were provided separately by direct procurement and are out of scope for this audit, there was an adviser for this process listed in the Tender Evaluation Plan for the PPP tender.

(C) In December 2005 Deloitte Touche Tohmatsu (referred to in this report as the 'Replacement Financial and Commercial Adviser') replaced Macquarie Bank Pty Ltd (referred to in this report as the 'Original Financial and Commercial Adviser') in the role.

(D) The role includes providing advice on probity matters, which is discussed in detail in Chapter 7.

Source: HQJOC Project Tender Evaluation Plan, v3-0, January 2006, pp. 14–15 and Defence advice provided on 9 April 2009.<sup>99</sup>

**2.14** The ANAO examined, for the Project's ten external advisers listed in Table 2.1 and the Prime Contractor, Defence's compliance with the contract reporting requirements of the following accountability and transparency mechanisms that apply to FMA Act agencies:

- Senate Order for Departmental and Agency Contracts;
- Defence's Annual Reports; and
- AusTender.

Senate Order for Departmental and Agency Contracts

**2.15** The CPGs contain the requirements relating to the Senate Order for Departmental and Agency Contracts (the Senate Order), including that FMA agencies list certain details within a specified period of time for contracts of \$100 000 or more on the Internet.<sup>100</sup>

<sup>99</sup> Defence subsequently advised the ANAO, as part of the agency's response to the proposed audit report, that the costs reported in Table 2.1 include funds allocated during the project's construction phase, in addition to the costs associated with the tender process.

<sup>100</sup> Department of Finance and Administration, op. cit., p. 22.

**2.16** ANAO Audit Report No.7 2007–08, *The Senate Order for Departmental and Agency Contracts (Calendar Year 2006 Compliance)* included a review of Defence’s performance for the calendar year 2006. The ANAO found that:

Defence, as a large user of contracts, has not been able to assure the completeness of its Internet listing. Indications are that it is two-thirds or more complete ... Defence advised the ANAO that it: ‘will fully comply with Finance guidelines for reporting contracts according to the Senate Order by 30 September 2007’.<sup>101</sup>

**2.17** A 2005–06 ANAO audit of Australian Government agencies’ reporting of expenditure on consultants noted that: ‘Defence has consistently indicated during the [ANAO’s] Senate Order audits [responses to six audits from 2001–02 to 2004–05] that it would have difficulty complying with the Senate Order, due principally to the sheer volume of its contracts’.<sup>102</sup>

**2.18** In this audit of the HQJOC Project, the ANAO accessed the following contract listings on Defence’s website compiled to fulfil the requirements of the Senate Order:

- 01/07/2007 to 30/06/2008 (financial year)
- 01/07/2006 to 30/06/2007 (financial year);
- 01/01/2007 to 31/12/2007 (calendar year);
- 01/01/2006 to 31/12/2006 (calendar year); and
- 01/01/2005 to 31/12/2005 (calendar year).

**2.19** The ANAO found that Defence’s website lists some contracts for the Project’s advisers as part of the Senate Order (for example, the engagement of a legal services provider for the Project Office). The names of some of the Project’s other advisers in Table 2.1 also appear in the website lists but cannot be connected with the Project on the basis of the description provided. Defence advised the ANAO that while the Project’s major contract with the Prime Contractor was not listed on Defence’s website in 2006, when the contract was

---

<sup>101</sup> ANAO Audit Report No.7 2007–08, *The Senate Order for Departmental and Agency Contracts (Calendar Year 2006 Compliance)*, p. 17.

<sup>102</sup> ANAO Audit Report No.27 2005–06, *Reporting of Expenditure on Consultants*, pp. 53–54.



signed, it was later added by Defence in April 2008 during the conduct of the ANAO's audit.<sup>103</sup>

### Defence's Annual Reports

**2.20** Defence, as an FMA agency, is required to publish details of all of its consultancies valued at over \$10 000 in its Annual Report.<sup>104</sup> Some consultancies relevant to the Project—with a contract value of \$10 000 or more (inclusive of GST)—are listed in the Internet version of Defence's Annual Reports from 2004–05 to 2006–07. However, similarly to the Senate Order listings, the names of some of the Project's other advisers appear in Defence's Annual Reports but cannot be connected with the Project on the basis of the description provided.

### AusTender

**2.21** The Gazette Publishing System, part of the AusTender website, contains listings for all of the Project's ten external advisers listed in Table 2.1, with most contracts described as being services for the HQJOC Project or HQAST (the Project's former name).<sup>105</sup> The Austender website also contains the details for Defence's contract with the Prime Contractor for the Project.

## Summary

**2.22** There is no direct correlation between Defence's reporting of contracts for the HQJOC Project in its Senate Order listing, Annual Reports on the Internet and the AusTender website and no consistent approach to identifying the contracts associated with the Project. However, the ANAO noted in a previous audit report (ANAO Audit Report No.27 2005–06, *Reporting of Expenditure on Consultants*) that the existence of three different regimes for

<sup>103</sup> Defence emails to the ANAO dated 4 December and 16 December 2008.

<sup>104</sup> ANAO Audit Report No.27 2005–06, *Reporting of Expenditure on Consultants*, sets out in detail the requirements for agencies to report on contracts including the following:

The *Requirements for Annual Reports for Departments, Executive Agencies and FMA Act Bodies*, published by the Department of the Prime Minister and Cabinet, require agencies to publish details of all consultancies valued at over \$10 000 that were let in the financial year.

Australian National Audit Office, op. cit., p. 16.

<sup>105</sup> The Gazette Publishing System website holds Australian Government contract information for the financial years up to and including 2006–07. The website advises that: 'Agencies subject to the *Financial Management and Accountability Act 1997* are required by the CPGs to publish on AusTender contracts and standing offers with a value of \$10 000 or more'. The website is available from <<http://www.contracts.gov.au>> [accessed 15 July 2008].

reporting contracts is a factor that militates against the accuracy and completeness of reporting.<sup>106</sup>

**2.23** The ANAO acknowledges that Defence has made available in the public domain the Prime Contractor's details, the timeframe and cost of the Project. But Defence has not fully complied with the requirements relating to the Senate Order, Annual Reports and AusTender for reporting the Project's contracts.

**2.24** Defence advised the ANAO, as part of the agency's response to the proposed audit report, that:

Defence acknowledges this oversight and did address these issues as soon as it became aware of the oversight. Defence has put in place arrangements through the establishment of the PPP Branch to ensure all future PPP proposals fully comply with all procurement requirements.<sup>107</sup>

## Public sector comparator (Project Cost Benchmark)

**2.25** The *Commonwealth Policy Principles for the Use of Private Financing* advises agencies that:

In the context of assessing a private financing proposal, value for money is to be tested by comparing the outputs and costs of private financing proposals against a neutral benchmark, called the Public Sector Comparator, developed by the agency (and its advisers) in consultation with the Private Financing Branch [in Finance].<sup>108</sup>

**2.26** Defence refers to a 'Public Sector Comparator' in the DPPM and in its *Private Financing Manual* to a 'Project Cost Benchmark' (PCB), and it is the latter term that Defence used in connection with the HQJOC Project.

**2.27** Defence's *Private Financing Manual* defines the PCB as:

an estimate of the whole of life cost of delivering a capability where Defence buys the capital equipment and facilities and then supports on-going delivery of the service needed to provide that capability. The estimate should be based

---

<sup>106</sup> Australian National Audit Office, op. cit., p. 60.

<sup>107</sup> Defence letter to the ANAO dated 9 April 2009.

<sup>108</sup> The term 'private financing' includes PPPs, which is how Defence describes the HQJOC Project. Department of Finance and Administration, p. 7.

on the most cost effective method and may include the use of outsourced maintenance and service delivery.<sup>109</sup>

**2.28** For the HQJOC Project, the PCB represents the direct procurement option and is based on an estimate of the capital and risk costs for Defence if the Project was to be undertaken by Defence with separate contracts for design, construction, maintenance and garrison support for the facility.

**2.29** The PCB is a tool that performs a dual role in informing discussion about where a private financing initiative will deliver VFM, compared to direct procurement, by providing a benchmark:

- initially, against which to test the commercial viability of a private financing approach; and
- later, against which private financing bids can be compared.<sup>110</sup>

Defence proposed to the Government in 2004 that detailing the risk, design and construction cost estimates for the Project in a PCB would negate the need to conduct a dual tender with both direct procurement and private financing options.

**2.30** Defence's use of the PCB was integral to: informing the Government's decision to proceed with a PPP for the Project; the assessment of tender responses; and, the subsequent selection of the Prime Contractor. Defence advised the Senate Foreign Affairs, Defence and Trade Legislation Committee on 1 June 2006 that the fact the proposed PPP financing arrangement showed a lower cost to government than the PCB was the most significant factor in the decision to proceed with a PPP for the Project rather than a direct procurement process.<sup>111</sup>

**2.31** The ANAO noted the following advice contained in the PCB versions signed by the then Director General Headquarters Joint Operations Command Project (DG HQJOC Project) on 23 February and 2 May 2005:

It should be noted that difficulties exist in developing a PCB because of the lack of accurate historical data and a basis for valuing risk. The PCB should be

---

<sup>109</sup> Department of Defence, *Private Financing Manual*, Canberra, 2002, p. 18.

<sup>110</sup> *ibid.*, p. 17.

<sup>111</sup> Official Committee Hansard, Senate Foreign Affairs, Defence and Trade Legislation Committee, Budget Estimates, Canberra, 1 June 2006, pp. 128–129.

viewed only as a quantitative way of informing judgement, as opposed to the definitive determinant of Value for Money.

**2.32** There are two components to the PCB:

- **base cost—raw PCB**—represents the whole of life cost of the ‘benchmark project’. The base cost includes all capital, operating and maintenance costs of Defence delivering the requirement, but not risk costs or contingencies often found in traditional budget estimates; and
- **transferable risk—risk adjusted PCB**—the value of those risks that Defence proposes to transfer to the private sector under a private financing arrangement. Under direct procurement, Defence would retain these risks, therefore, their value needs to be estimated and added to the base cost.<sup>112</sup>

**2.33** Table 2.2 shows the timing of Defence’s release of the raw PCB to the Project’s tenderers. The purpose of issuing the raw PCB developed by the PCB Working Group (including representation from Defence, Finance and the Project’s expert advisers) was to give the tenderers guidance as to the Project’s scope and affordability. The risk adjusted PCB was not released to the tenderers as it was used by Defence to assist with assessing the overall VFM of the tenderers’ responses.

## Discount rate

**2.34** The final key component to the PCB is the use of a discount rate to calculate the cost of the base case and transferable risk in Net Present Cost (NPC) terms.<sup>113</sup> To calculate the NPC of the PCB, Defence’s *Private Financing Manual* advises:

use a discount rate equal to the 10-year bond rate ... The issue of appropriate discount rate in a given circumstance will need to be examined and projects

---

<sup>112</sup> Examples of the transferable risks proposed for the HQJOC Project included: the risk of the impact of the conditions of approval of the Environmental Impact Statement; the risk arising from any industrial action; and the risk of the contractor not meeting the completion date.

<sup>113</sup> ‘Discount rate’ is the percentage rate applied to cash flows to calculate the present value of future cash flow streams to enable comparisons to be made between payments made at different times. The rate quantifies both the time value of the future cash flow streams and the risk of the relative cash flow streams.

‘Net Present Cost’ (NPC) is the equivalent cost at a given time of a stream of future net cash outlays (calculated by discounting the values at the appropriate discount rate).

should consult with the Directorate of Private Financing and Commercial Support.<sup>114</sup>

**2.35** At the beginning of the tender process, the discount rate for the PCB was 5.60 per cent. Based on a change to the 12 month average of the Commonwealth Government Bond rate as at 15 February 2005, Defence changed the rate to 5.55 per cent in February 2005. In January 2006, following advice from Finance, Defence updated the discount rate for the final time to 5.35 per cent, based on the three month average of the 10 year Commonwealth Government Bond rate from October–December 2005, and in accordance with the Government’s private financing policy. (Defence’s use of the discount rate is discussed in Chapters 3, 5 and 6).

### Developing the HQJOC Project Cost Benchmark

**2.36** Table 2.2 represents the development of the Project’s PCB. In accordance with the *Commonwealth Policy Principles for the Use of Private Financing* (see paragraph 2.25), Defence also formed a Project Cost Benchmark Working Group that met seven times between September 2004 and February 2005. Members of the Working Group included Defence and relevant external advisers to the Project, who regularly attended meetings (see paragraph 2.13 for details of Defence’s advisers), and a representative from Finance also attended two meetings. Finance’s involvement in the development of the PCB continued on a direct basis with Defence through to the completion of the PCB for the final stage of the tender process in January 2006.

**Table 2.2**

#### Key events in the development of the HQJOC Project Cost Benchmark

Date	Key event
9 March 2004	Initial PCB considered by the Government.
1 September 2004	Raw PCB (\$458.8 million) issued to tenderers with Request for Tender documentation.
31 January 2005	Revised raw PCB (\$473.4 million) issued to tenderers during Request for Tender stage.
11 May 2005	Raw PCB (\$541.4 million) issued to tenderers during Request for Revised Offer stage.

<sup>114</sup> Department of Defence, op. cit., p. 22.

Date	Key event
28 October 2005	Raw PCB (\$319.5 million) issued to tenderers during Request for Final Revised Offer (RFRO) stage. <sup>A</sup>
27 January 2006	Updated PCB model finalised for use in assessing RFRO tenders.

Note: (A) The decrease in the raw PCB between 11 May 2005 and 28 October 2005 reflects a change to the Output Specification for the Project. See Chapter 3 for details.

Source: ANAO analysis.

**2.37** In between the issuing of the raw PCB to tenderers shown in Table 2.2, the PCB went through several iterations based on reviews and adjustments recommended by Defence's external advisers and the Design and Construction, and Financial Tender Evaluation Working Groups (TEWGs) (see Chapter 3 for an explanation of the role of the working groups).

**2.38** Chapter 5 explains Defence's use of the PCB as a central evaluation tool during the tender.

#### *Finalising the Project Cost Benchmark*

**2.39** Table 2.3 shows the timing for finalising the PCB and the receipt and opening of the tenderers' responses to the final stage of the tender. The final version of the PCB, developed by the Project's Replacement Financial and Commercial Adviser, contains the assumptions provided by a number of Defence's advisers on risk, capital and operating costs.<sup>115</sup>

**Table 2.3**

#### **Finalising the HQJOC Project Cost Benchmark**

Date	Activity
19 January 2006	<ul style="list-style-type: none"> <li>Final stage of the HQJOC tender closed.</li> <li>Tender responses received and opened.</li> <li>Tender Evaluation Plan finalised by the DG HQJOC Project.</li> </ul>
20 January 2006	<ul style="list-style-type: none"> <li>Risk adjusted PCB finalised by the DG HQJOC Project.</li> <li>Initial screening of tender responses.</li> </ul>
25 January 2006	<ul style="list-style-type: none"> <li>Risk adjusted PCB updated after receipt of revised financial indices from Finance.</li> </ul>
27 January 2006	<ul style="list-style-type: none"> <li>Replacement Financial and Commercial Adviser sent Defence the final updated PCB.</li> </ul>

Source: ANAO analysis.

<sup>115</sup> See Table 2.1 for a list of the Project's key external advisers.

**2.40** The Project's Tender Evaluation Plan (TEP) advises that: 'The seal on each bundle (individual tender response) will not be broken until this TEP (including the Financial TEWG Evaluation Guidance) has been completed and signed off.' The Evaluation Guidance sets out how the PCB is to be used to assess the NPC of the Project, and thus the PCB is an essential part of the financial guidance. However, as can be seen in Table 2.3, Defence opened the tender responses the day before the PCB was finalised.

**2.41** The initial screening procedure, according to the Source Selection Report (February 2006), took place the day after the tenders were opened on 20 January 2006. The procedure is described in detail in the TEP as purely a compliance process that takes place immediately after tender closing time to ensure that the tenders are complete and includes specific guidance that: 'there is NO evaluation of Tender Responses'.<sup>116</sup> The TEP also details the secure storage, access and release arrangements for the pricing information contained in the tenderers' responses if an update to the PCB was required following the anticipated release by the Treasury of updated economic parameters in January 2006 (see Table 2.3).<sup>117</sup>

**2.42** The ANAO discussed the timing of the finalisation of the PCB and consideration of the final stage tender responses with Defence and received assurances from Defence that even though the tenders were received and opened the day before the PCB was finalised by the DG HQJOC Project, the responses were not assessed until after the PCB was finalised. The Project's Legal Process Adviser's probity sign-off at the end of the Project did not comment on Defence's process for finalising the PCB or opening the final tender responses.

**2.43** The ANAO considered that, given the close proximity of the completion of the PCB to the opening of the tenders, this carried risks for the integrity of the tender process. Critical tools or evaluation material necessary to assess tender responses, such as the PCB, should be finalised well in advance of opening the tender.

---

<sup>116</sup> Department of Defence, HQJOC Project Tender Evaluation Plan v3-0, 19 January 2006, p. 67.

<sup>117</sup> *ibid.*, pp. 27-28.

## 3. Tender Process

---

*This chapter discusses key aspects of Defence's management of the HQJOC tender process, including the final assessment of value for money and identifying a preferred tenderer.*

### Introduction

**3.1** The tender process for the Project began in early April 2004 and culminated in the selection of a preferred tenderer by the Government in late April 2006.

**3.2** This chapter describes the timing and stages in the Project's tender process leading up to Defence's recommendation of a preferred tenderer to the Government. As discussed in Chapter 2, there are three core principles in the *Commonwealth Policy Principles for the Use of Private Financing*—VFM, transparency, and accountability. The primary focus in this chapter is an analysis of Defence's assessment procedures during the tender process to determine whether or not the Project would deliver VFM under a PPP arrangement.<sup>118</sup>

**3.3** This chapter examines the following:

- Project tender documents;
- Organisational structure for the tender evaluation; and
- The tender: a four stage process.

### Project tender documents

**3.4** Chapter 2 outlined the Government's procurement policy framework and Defence's procurement procedures and guidelines that were relevant to the HQJOC tender.<sup>119</sup> A series of detailed Tender Evaluation Plans (TEPs) was

---

<sup>118</sup> The *Commonwealth Procurement Guidelines* (2005) state that: 'Value for money in a procurement process ... requires a comparative analysis of all relevant costs and benefits of each proposal throughout the whole procurement cycle (whole of life costing)'. Department of Finance and Administration, op. cit., p. 10.

<sup>119</sup> Of particular relevance to the HQJOC Project were:

- Finance's *Commonwealth Policy Principles for the Use of Private Financing* (2002); and
- Defence's *Private Financing Manual* (2002) and the *Defence Procurement Policy Manual* (2005).



drafted, primarily by the Project's Legal Process Adviser in consultation with the HQJOC Project Office and its advisers, and each update was approved by the DG HQJOC Project for each stage of the tender process (see paragraph 3.11 for a description of the stages in the tender). In total, three plans were drafted as follows:

- (a) TEP V1-0, approved 21 February 2005;
- (b) TEP V2-0, approved 31 May 2005; and
- (c) TEP V3-0, approved 19 January 2006.<sup>120</sup>

**3.5** In addition to the TEP, the HQJOC Legal Process Adviser developed a 34 page *Process Plan* (also discussed at paragraph 7.9 in Chapter 7). The *Process Plan*, originally designed for a single round tender, was not updated to cover what became a multi-round tender process for the Project (see Table 3.2 for the tender's schedule). However, the plan was sufficiently generic to accommodate the additional unplanned rounds in the tender process.

**3.6** According to the *Process Plan*, the Legal Process Adviser was to report and provide a sign-off to the DG HQJOC Project on the Project's overall level of compliance with the stated probity requirements at key milestones during the Project's tender and at the end of the contract negotiation and finalisation phase. See paragraph 3.66 regarding the Legal Process Adviser's final End of Project Report.

**3.7** The final pieces of major guidance material for the HQJOC tender were the tender documents produced by Defence and made available to the tenderers (AZ 2895, AZ 2931, AZ 3100 and AZ 3206). Defence advised the tenderers that their responses would be evaluated against the: 'declared Evaluation Criteria and the Evaluation Baseline. The Evaluation Baseline consists of the Output Specification, the PCB and the draft Project Documents'.<sup>121</sup>

---

<sup>120</sup> The final version of the TEP is 125 pages in total. According to the DPPM, the purpose of a TEP is to: '(record) the method by which tenders for a requirement will be evaluated, including the evaluation criteria and the relevant probity requirements'. Department of Defence, op. cit., p. 10.

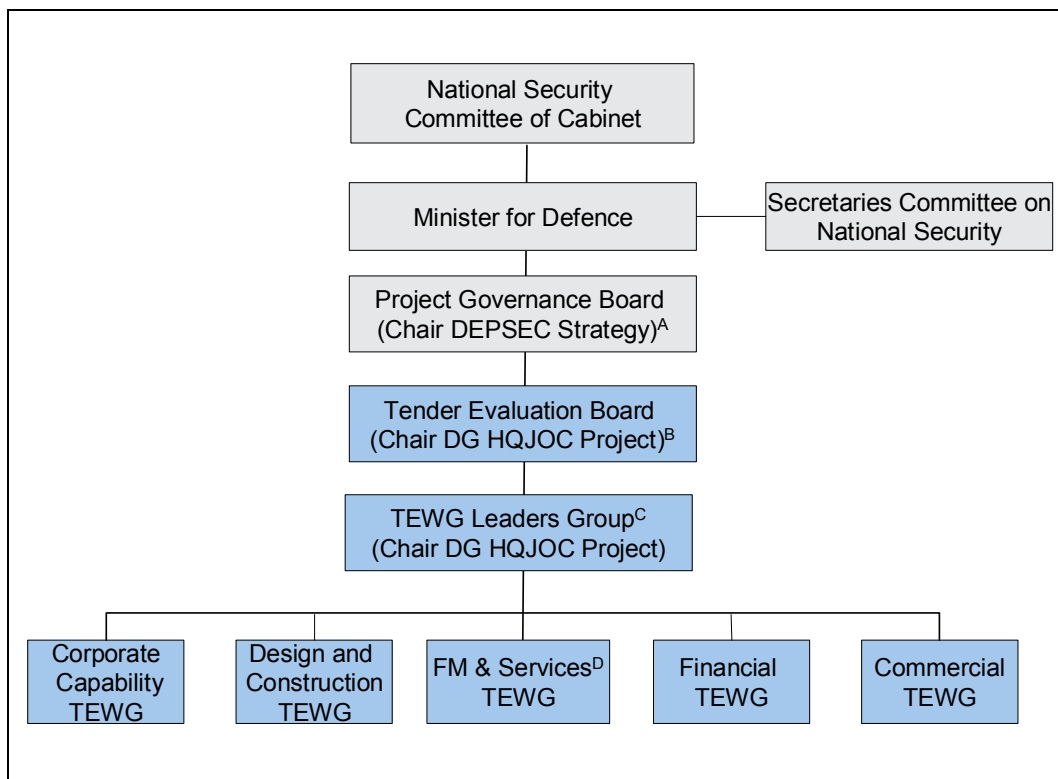
<sup>121</sup> Department of Defence, op. cit., p. 18.

## Organisational structure for the tender evaluation

3.8 The TEP specifies the structure, membership and responsibilities of the various bodies involved in evaluating the HQJOC tender.<sup>122</sup> Figure 3.1 is a diagrammatic representation of the tender evaluation organisation created by Defence for the Project.

Figure 3.1

### HQJOC tender evaluation organisation



Notes: (A) DEPSEC: Deputy Secretary.

(B) DG HQJOC: Director General Headquarters Joint Operations Command.

(C) TEWG: Tender Evaluation Working Group.

(D) FM: Facilities Management and Service Delivery.

Source: Department of Defence, HQJOC Project Tender Evaluation Plan v3-0, 19 January 2006, p. 9.

<sup>122</sup> Defence established a Board of Governance in October 2001 to oversee the Project, which was replaced by a Project Governance Board in February 2005.

3.9 Table 3.1 summarises the membership and responsibilities of the organisations represented in Figure 3.1.

**Table 3.1**

**Evaluation organisation bodies: membership and responsibilities**

Evaluation body	Membership agencies/organisations <sup>A</sup>	Responsibilities
National Security Committee	Prime Minister (Chair). Deputy Prime Minister. Attorney-General. Minister for Defence. Minister for Foreign Affairs. Treasurer.	<ul style="list-style-type: none"> <li>• Approving authority for the preferred tenderer (acting on the advice of the Defence Minister).</li> </ul>
Project Governance Board	Defence. Finance. Treasury (observer). Australian Government Solicitor (AGS) (Legal Process Adviser and Secretary).	<ul style="list-style-type: none"> <li>• Oversee evaluation process.</li> <li>• Monitor project health and outcomes.</li> <li>• Ensure compliance with CPGs and DPPM.</li> <li>• Provide guidance to the Tender Evaluation Board on the evaluation process.</li> </ul>
Tender Evaluation Board	Defence and Finance. AGS (Legal Process Adviser and Secretary).	<ul style="list-style-type: none"> <li>• Ensure propriety and integrity guidelines are followed.</li> <li>• Oversee the evaluation process and ensure compliance with the key tender documents and the procurement framework.</li> <li>• Undertake the value for money assessment.</li> <li>• Approve the Initial Screening, Setting Aside and Source Selection Reports.</li> </ul>

Evaluation body	Membership agencies/organisations <sup>A</sup>	Responsibilities
TEWG Leaders Group	Defence. AGS (Legal Process Adviser and TEWG Facilitator). Deloitte (Replacement Financial and Commercial Adviser). Capital Insight (Risk Adviser). Connell Wagner (Output Specification Adviser). APP Corporation Pty Ltd (Project Consultant and Secretary).	<ul style="list-style-type: none"> <li>Oversee activities of the TEWGs, including facilitating and coordinating TEWG evaluation.</li> <li>Ensure TEWG evaluations comply with the Tender Evaluation Plan.</li> <li>Advise TEWGs, as required.</li> <li>Facilitate liaison and information sharing about issues of conformance and risk between TEWGs.</li> <li>Provide progress reports to the Chair and members of the TEB.</li> <li>Consolidate TEWG evaluations for the TEB.</li> <li>Oversee the development of any Continuing Screening or Setting Aside Reports.</li> </ul>
TEWGs: 1. Corporate Capability. 2. Design and Construction. 3. Facilities Management and Service Delivery. 4. Financial. 5. Commercial.	<ol style="list-style-type: none"> <li>Defence and Connell Wagner (Output Specification Adviser).<sup>B</sup></li> <li>Defence, Connell Wagner (Output Specification Adviser), Capital Insight (Risk Adviser), ASIO, Bill Szydluk Architects (Architectural Adviser).</li> <li>Defence and CW Consulting.</li> <li>Defence, Finance and Deloitte (Replacement Financial and Commercial Adviser).</li> <li>Defence and Blake Dawson (Legal Adviser).</li> </ol>	<ul style="list-style-type: none"> <li>Evaluate tender responses applicable to each TEWG's evaluation category.</li> <li>Rank tender responses within the relevant evaluation category.</li> <li>Prepare clarification questions, if needed.</li> <li>Identify issues for negotiation should a tenderer be selected as preferred.</li> </ul>

Notes: (A) There were some membership changes over time. The information in the table was current as at 19 January 2006.

(B) The TEWGs were assisted by a number of specialist advisers, predominantly the HQJOC Project advisers listed in Table 2.1, in Chapter 2.

Source: Department of Defence, HQJOC Project Tender Evaluation Plan v3-0, 19 January 2006, pp. 8-14.

**3.10** Overall, the governance and evaluation structure established for the Project, including support from external expert advisers and relevant Australian Government agencies, was sufficiently comprehensive to have ensured that Defence had the ability to comply with the Australian Government's procurement policy framework and Defence's own procurement procedures and guidelines for the Project.

## The tender: a four stage process

**3.11** As discussed in Chapter 1, the November 2003 *Acquisition Business Case* for the Project included a tendering schedule as part of the overall project delivery schedule. It is reasonable to expect that the actual delivery of a complex project requiring government approvals at multiple stages, such as the HQJOC Project, might vary from the initially proposed schedule.<sup>123</sup>

**3.12** The ANAO noted that in the *Acquisition Business Case* the proposed process, and therefore schedules, are the same for a PPP and direct procurement through the Government approvals phase of the Project, but differ in the tendering phase. The PPP schedule was noticeably longer with the inclusion of a financial close process, which is not required for a direct procurement.<sup>124</sup> Defence suggested that the schedule difference was most likely due to the inherent complexity of PPPs and the Department's limited experience using the approach. In the delivery schedule, the estimated full completion and occupancy date was also later for the PPP option, due to a different schedule for construction and subsequent installation of the C4I systems.

## Tender schedule

**3.13** The HQJOC tender process took longer than Defence originally planned. Table 3.2 shows the timetable for the tender included in the three versions of the TEP (see paragraph 3.4) and the actual date Defence achieved key milestones during the tender. The final planned target date for Defence to

<sup>123</sup> A literature review of articles on international PPPs conducted by the ANAO's audit team noted that in the United Kingdom PPP projects, once started (post-tender), have been delivered within budget and on time. Additionally, the literature indicates that cost or schedule increases during the tender phase are often attributable to governments changing asset specifications. National Audit Office, *PFI: Construction Performance*, Report HC 371 Session 2002–03, NAO, London, 2003, pp. 2–6.

<sup>124</sup> Under a PPP, financial close occurs when the private sector partner's financiers conclude the financial aspects of the transaction.

be able to occupy and operate the facility from 14 November 2008 was met, but it was 11 months later than originally planned at the beginning of the tender process.<sup>125</sup>

**Table 3.2**

**Tender schedule: planned and actual dates**

Tender milestone activity	Tender Evaluation Plan Version 1	Tender Evaluation Plan Version 2	Tender Evaluation Plan Version 3	Actual date
Invitation to Register Interest (ITR) issued	—	—	—	2 April 2004
ITR closed	—	—	—	27 May 2004
Request for Tender (RFT) issued	—	—	—	1 September 2004
RFT closed	22 February 2005	22 February 2005	22 February 2005	22 February 2005
Request for Revised Offer (RRO) issued	—	2 May 2005	—	2 May 2005
RRO closed	—	3 June 2005	—	3 June 2005
Request for Final Revised Offer (RFRO) issued	—	—	24 October 2005	24 October 2005
RFRO closed	—	—	19 January 2006	19 January 2006
Government approval of the preferred tenderer assessment	15 June 2005	9 August 2005	March/April 2006	26 April 2006
Commercial close (contract signature)	—	9 September 2005	May 2006	30 June 2006
Financial close	17 August 2005	10 October 2005	June 2006	28 July 2006
Target availability date	1 September 2007	31 January 2008	—	11 July 2008 <sup>A</sup>

<sup>125</sup> The 'target availability' and 'target occupancy' dates in Table 3.2 appear in the HQJOC Project Deed as 9 July 2008 and 14 November 2008 respectively. The actual dates were confirmed by Defence media announcements.

Tender milestone activity	Tender Evaluation Plan Version 1	Tender Evaluation Plan Version 2	Tender Evaluation Plan Version 3	Actual date
Target occupancy date	14 December 2007	Mid-2008	—	14 November 2008 <sup>A</sup>

Note: (A) The target availability date in the HQJOC Project Deed was 9 July 2008. Defence announced that construction of the facility was complete on 11 July 2008. The target occupancy date in the HQJOC Project Deed was 14 November 2008.

Source: ANAO analysis.

**3.14** Table 3.2 shows the four stages in the HQJOC tender as follows:

- Invitation to Register Interest (ITR)—Defence received responses from seven consortia;
- Request for Tender (RFT)—Defence issued the RFT to three shortlisted consortia;
- Request for Revised Offer (RRO)—Defence issued the RRO to the three RFT shortlisted consortia; and
- Request for Final Revised Offer (RFRO)—Defence issued the RFRO to the three RFT shortlisted consortia.

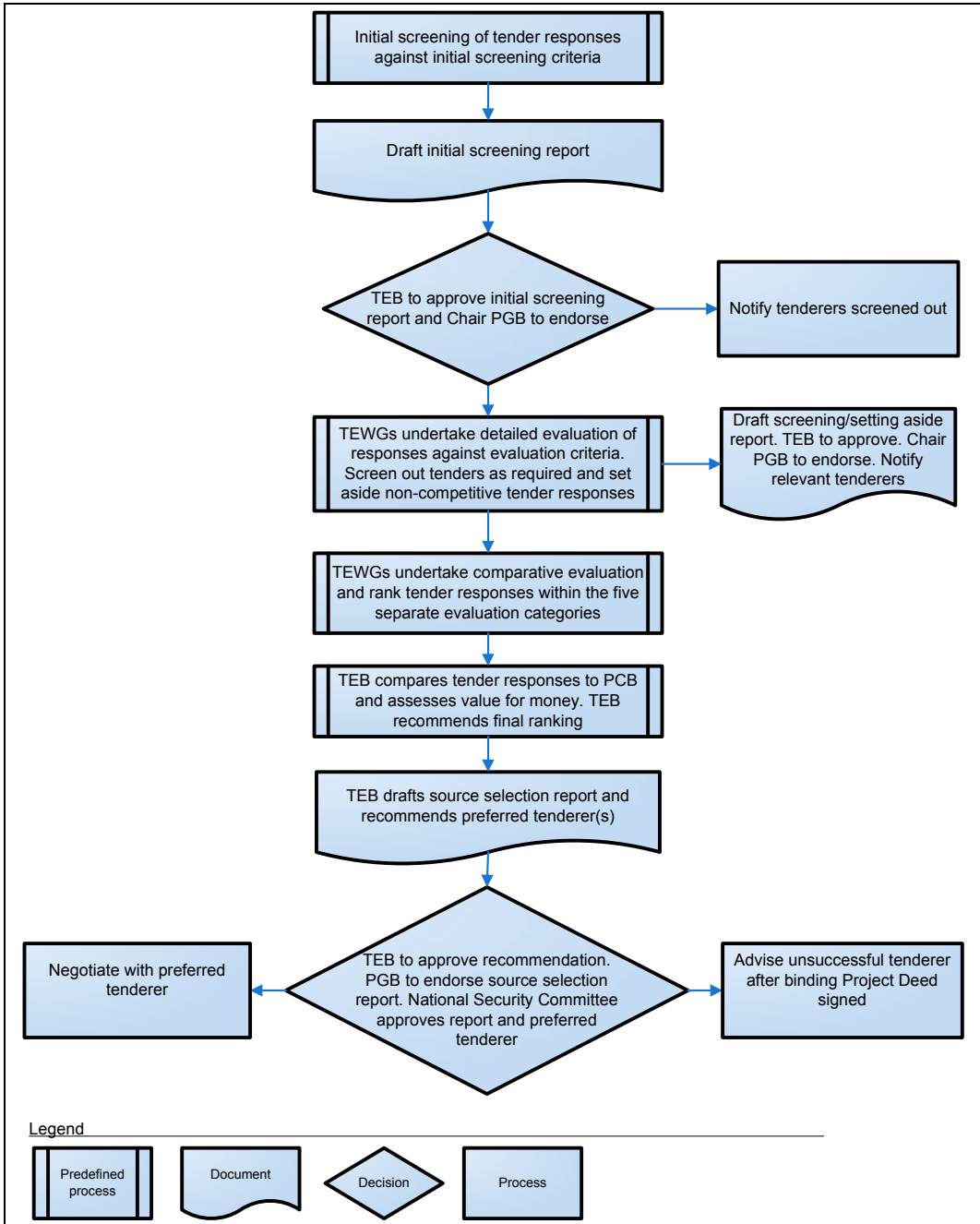
**3.15** The next sections in this chapter discuss Defence's tender evaluation strategy from ITR to RFRO.

## Evaluation strategy

**3.16** A similar evaluation strategy was set out in each of the three TEPs. The evaluation strategy is represented in Figure 3.2.

**Figure 3.2**

**Tender evaluation process**



Source: ANAO analysis.



## Stage 1: Invitation to Register Interest (ITR)

**3.17** International experience is that the complexity and long timeframes associated with PPP projects mean tendering is expensive and can limit the extent of competition.<sup>126</sup> However, Defence received seven responses to the HQJOC ITR when it was issued in April 2004. The ITR informed the market of the Project, its components, proposed delivery structure and timetable, and Defence's evaluation criteria for shortlisting respondents.

**3.18** Four working groups—Mandatory Requirements, Capability, Technical and Financial Evaluation—assessed the ITR responses against the evaluation criteria in the HQJOC ITR Evaluation Plan, which were drawn from the ITR documents. The evaluation resulted in: two of the seven responses being excluded as they had not met the mandatory requirements,<sup>127</sup> of the five remaining responses, all were ranked as suitable, but only the top three were shortlisted to proceed to the RFT stage and submit detailed tenders.

**3.19** The ITR evaluation followed a similar model to the evaluation process outlined in Figure 3.2 although:

The recommendation of the [ITR] Evaluation Board to shortlist [three consortia] was endorsed by the Project Board of Governance on 18 August 2004, and approved by Head Infrastructure Division as the delegate on 24 August 2004.<sup>128</sup>

**3.20** The Minister for Defence was asked to note that three consortia had been shortlisted for the RFT, which was consistent with the *Process Plan* and the ITR Evaluation Plan. The ITR advised that Defence would select a shortlist of three or four respondents—a number sufficient to ensure a competitive result—who may subsequently be invited to submit a response to the RFT.

---

<sup>126</sup> For example, the number of bidders per PPP project in the United Kingdom has decreased over time: since 2004 there has been an 18 per cent drop in projects attracting three or more bidders, linked to the long and expensive tendering process. Antony Barton, *PFI deals put bidders off*, Supply Management, Volume 12, No.15, 2007, p. 10.

<sup>127</sup> The mandatory requirements were compliance with the *National Code of Practice for the Construction Industry* and Australian Government Industry Guidelines, security, and equal opportunity legislation.

<sup>128</sup> Department of Defence, Minute, DEPSEC CS/OUT/2004/235, 25 August 2004, pp. 9–10.

## Stage 2: Request for Tender (RFT)

3.21 A ministerial media release issued on 1 September 2004 announced that Defence would invite the Prime Contractor and two others to respond to the HQJOC RFT.<sup>129</sup> The three shortlisted consortia and their members were:

- Praeco (Leighton Contractors, Leighton Services and Boeing Australia Limited, which was later replaced by ABN AMRO) (referred to as the Prime Contractor in this report);
- Australian Defence Capability Partnership, later renamed Australian Command Capability Partnership (Bilfinger Berger, Boulderstone Hornibrook, United KG) (referred to as Consortium A in this report); and
- Synersec (Multiplex Group, Multiplex Infrastructure, Multiplex Constructions, Multiplex Facilities Management, Westpac Banking Corporation) (referred to as Consortium B in this report).

3.22 On the same day, Defence invited the three shortlisted consortia to provide a detailed tender response for the construction and operation of the HQJOC facility.<sup>130</sup> The RFT clearly states that the Commonwealth was not committing to proceed with the Project or the delivery of the Project via a PPP. The RFT stage closed on 22 February 2005 (see Table 3.2).

### *Two changes to consortia membership*

3.23 The RFT required tenderers to obtain Defence's consent to any material change to the membership of a consortium after the submission of its ITR response. Prior to the close of the RFT, the Prime Contractor advised Defence of a change to its consortium membership, while Consortium A advised Defence of a change in its name.

3.24 The Prime Contractor requested requalification of its tender on 7 December 2004 to take account of two changes: the inclusion of ABN AMRO as a consortium member; and Boeing Australia Limited withdrawing from membership and becoming an adviser. Defence agreed to the addition of ABN AMRO as a member on 27 January 2005.

---

<sup>129</sup> Department of Defence, *Tenderers Shortlisted for New Joint Defence HQJOC* [Internet]. Department of Defence, Canberra, 2004, available from <<http://www.defence.gov.au>> [accessed 5 June 2008].

<sup>130</sup> Defence issued seven Addenda to the RFT between 4 November 2004 and 10 February 2005.

**3.25** Subsequently, at the request of the HQJOC PGB at its meeting held on 15 March 2005, Defence sought written advice from the Project's Legal Process Adviser about the impact on the tender of the Prime Contractor's request for requalification of its tender. The legal advice was provided to Defence on 15 April 2005, approximately three months after the Project Office had already approved the Prime Contractor's inclusion of ABN AMRO as a consortium member.

**3.26** The PGB considered the legal advice obtained by Defence at its next meeting on 19 April 2005. The PGB noted the advice including that Defence had not yet agreed to Boeing Australia Limited withdrawing from membership of the consortium and becoming an adviser. The PGB concluded that Boeing Australia Limited's withdrawal from membership of the consortium would not impact on the Prime Contractor's proposed delivery of facility management services. The PGB also considered that it was appropriate for the Prime Contractor to proceed into the tender evaluation.

**3.27** On 5 November 2004, Consortium A advised Defence that the Australian Securities and Investment Commission had raised concerns over the reference to 'Defence' in its name. As a result, the consortium changed its name to 'Australian Command Capability Partnership'. The tender's Source Selection Report from July 2005 states that: 'Legal and probity advice to the HQJOC Project determined that this change of company name did not in these circumstances require requalification of the tender'.<sup>131</sup>

**3.28** The ANAO considers that Defence acted in accordance with the processes specified in the HQJOC tender documents for managing changes to consortia membership. Furthermore, Defence's actions during the RFT stage in relation to these matters did not adversely impact upon the tender evaluation process.

## **Responses to Request for Tender**

**3.29** Defence attached a copy of the proposed Project Deed to the RFT and advised tenderers that they would be: 'expected to enter into a contract with the Commonwealth substantially in the form of the Project Deed'.<sup>132</sup> Defence

---

<sup>131</sup> Department of Defence, HQJOC Project Source Selection Report, July 2005, p. 14.

<sup>132</sup> Department of Defence, Headquarters Joint Operations Command Project, Request for Tender AZ 2931, September 2004, clause 3.4 (f), p. 10.

also attached the Output Specification to the RFT. The Output Specification explains the scope of services and minimum standards the tenderers would be expected to meet in their responses, notably:

It is anticipated that specifying the Commonwealth's requirements, rather than how the Facility and Off Site Facilities are to be constructed and maintained, will afford Tenderers the opportunity to prepare effective Tender Responses and offer innovative solutions that, ultimately, will offer better value for money than a prescriptive approach specifying a set of pre-determined inputs developed by the Commonwealth.<sup>133</sup>

**3.30** Both the *Commonwealth Policy Principles for the Use of Private Financing* and *Defence's Private Financing Manual* cite 'innovation' as a potential benefit to be gained from the use of PPPs.

**3.31** The RFT specified that each tenderer must submit a Standard Tender Response (STR), as defined in the RFT, and failure to comply would mean that any Alternative Tender Response(s) (ATR), as defined in the RFT, would not be considered.<sup>134</sup> The tenderers' use of both STRs and ATRs was a central feature of the HQJOC tender and the Government's decision as to the preferred tenderer for the Project, which is discussed in detail in Chapter 4. Defence had the ability to reject a tender response, subject to the factors specified in the RFT. In addition, tender responses were required to remain

---

<sup>133</sup> *ibid.*, clause 3.4(e), p. 10.

<sup>134</sup> The RFT contains one page of detailed advice defining a 'Standard Tender Response (STR)' and a second page of advice for an 'Alternative Tender Response (ATR)'. The key features of a STR, as described in the RFT, are:

- Each tenderer must submit a STR. A failure by any tenderer to lodge a STR will automatically result in the Commonwealth rejecting all tender responses submitted by that tenderer.
- STRs should contain a mark-up, where the tenderer considers a mark-up appropriate, of the Part 3 documents. (Part 3 contains the Project Deed, other contractual documents and Schedule 4 of the Project's Output Specification. The preferred tenderer will be expected to enter into a contract with the Commonwealth substantially in the form of the Project Deed.)
- Any alternative allocation of the risks associated with key contractual provisions of the Project Deed must be presented in a ATR and priced accordingly.

The key features of an ATR, as described in the RFT, are:

- In addition to a STR, tenderers may submit ATRs, being a tender response that proposes a payment mechanism or risk allocation that does not meet the requirements of a STR.
- The Commonwealth may consider an ATR only if the tenderer has also submitted a STR, and the Commonwealth considers that the ATR fully describes the advantages and disadvantages of the proposed payment mechanism or risk allocation, including any pricing advantages from the proposal, and includes sufficient information to allow comparison of the ATR with STRs.

unconditionally open for acceptance by the Commonwealth for a period of nine months from the closing date of the RFT. Table 3.3 shows the responses received by Defence to the RFT from the three shortlisted consortia invited to submit a tender response.

**Table 3.3**

**Tenderers' responses to the HQJOC Request for Tender AZ 2931 (issued 1 September 2004)**

Tenderer	Standard Tender Response	Alternative Tender Response	Non-conforming (rejected) Response
Prime Contractor	1	3	0
Consortium A	1	2	0
Consortium B	1	1	0

Source: ANAO analysis.

*Final evaluation: Source Selection Report*

**3.32** The RFT tender evaluation was to be conducted in accordance with the TEP V1-0, approved 21 February 2005 (see paragraph 3.4), at the Barn.<sup>135</sup> The evaluation was scheduled to start on 28 February 2005 and finish by mid-June 2005 (the actual end date was 2 May 2005). As described in paragraphs 3.8–3.9 and 3.16, the RFT responses were evaluated against five criteria contained in the RFT, and mirrored in the TEP.<sup>136</sup> Responses were further evaluated on a VFM basis using the PCB. The RFT documentation advised the tenderers that: ‘The Evaluation Criteria are not listed in any particular order and may not be accorded equal weight. Any weighting applied to the Evaluation Criteria will not be made available to Tenderers.’<sup>137</sup> There is no indication that a weighting

<sup>135</sup> The Barn is a high security building located in Defence Establishment Fairbairn in the Australian Capital Territory that was used to conduct the tender evaluation.

<sup>136</sup> The five evaluation criteria were:

- Whole of Life Corporate Capability;
- Design and Construction;
- Facilities Management and Service Delivery;
- Financial; and
- Commercial.

<sup>137</sup> Department of Defence, op. cit., clause 9.2(b), p. 34.

or priority was assigned to the evaluation criteria in any of the three versions of the TEP.

**3.33** The RFT TEP specifies that the Tender Evaluation Board (TEB) will produce a final evaluation report—known as the Source Selection Report—that includes a recommendation as to a preferred tenderer. The report was to be developed by the DG HQJOC Project, assisted by the TEWG Leaders. Defence advised the ANAO during audit fieldwork that a Source Selection Report was not produced for the RFT stage because none of the tender responses were compliant—that is, capable of acceptance under the RFT, Defence’s *Private Financing Manual* and the *Commonwealth Policy Principles for the Use of Private Financing*.

**3.34** Defence advised the Minister for Defence on 29 April 2005 that:

The evaluation of all [RFT] tender responses has not identified any tender that offers value for money to the Commonwealth when assessed against the [risk adjusted] Project Cost Benchmark, with responses exceeding the Project Cost Benchmark by 10 to 43 percent. The tender evaluation team has advised that in a number of areas the tenderers have misinterpreted the Project’s Request for Tender Output Specifications and have exceeded the required scope of the facilities to be provided, leading to the price variations. The tenderers have also proposed changes to the risk allocations detailed in the Project documents, which has contributed to the price variations.<sup>138</sup>

On a NPC basis, Defence assessed that the individual tenderers’ responses exceeded the PCB by \$121.0 million, \$206.4 million and \$332.0 million.

**3.35** In response to the proposed audit report, the Prime Contractor commented as follows:

The very limited interaction allowed between the bidders and Department of Defence advisers/personnel to clarify the output specification led to none of the bidders meeting the benchmark costs in the first rounds of bids.<sup>139</sup>

**3.36** In this respect, the ANAO notes that during the RFT Defence briefed the three shortlisted tenderers on the RFT, and received reciprocal presentations from the tenderers. In addition, Defence held site visits and

---

<sup>138</sup> Department of Defence, Minute HQJOC Project 392/2005, *Headquarters Joint Operations Command Project Tender Evaluation of Private Finance Components*, 29 April 2005, paragraph 3, p. 2.

<sup>139</sup> Praeco Pty Limited letter to the ANAO dated 9 April 2009.

responded to tenderers' questions. Defence also provided the raw PCB to tenderers at the RFT stage to give tenderers guidance as to the Project's scope and affordability. However, from examining various documents produced by Defence at the time, it is clear that the tenderers' interpretations of the RFT Output Specification contributed significantly to the unsatisfactory outcome for Defence from this tender round. The final outcome indicates that, despite Defence's efforts, a communication gap existed between the tender documents and Defence's expectations in relation to innovative solutions.

**3.37** The ANAO encouraged Defence to evaluate its approach to fostering innovative tender responses to RFTs for any future PPPs, which could be of benefit to Defence by reducing the need for additional tender rounds.

**3.38** Defence finalised a Source Selection Report in July 2005 that aimed to: 'provide an auditable and defensible record of the evaluation and the Responses received to the RFT and the RRO for the Project.'<sup>140</sup> The report predominantly focuses on the RRO evaluation and contains limited detail, in summary form, for the RFT evaluation. Although, the report advises that the TEB determined that no tenderer had submitted a response capable of acceptance under the RFT.

### **Stage 3: Request for Revised Offer (RRO)**

**3.39** As discussed in the preceding section, Defence issued a Request for Revised Offer (RRO) on 2 May 2005. The purpose of the RRO was for the Commonwealth to: 'receive improved and revised proposals from each Respondent, which contain traceable revisions to the Respondent's Original Tender Responses, which satisfy the Evaluation Criteria and are capable of acceptance'.<sup>141</sup> The RRO documents advised that Defence would provide the tenderers with additional information, based on issues identified in their individual RFT response, to assist with preparing their RRO response.<sup>142</sup> Defence also made amendments to the Project Deed and Output

---

<sup>140</sup> Department of Defence, Source Selection Report July 2005, paragraph 4, p. 10. The report was prepared by the DG HQJOC Project, as Chair of the Tender Evaluation Board, on 5 July 2005, and endorsed by the Acting Chair of the Project Governance Board on 6 July 2005.

<sup>141</sup> Department of Defence, Headquarters Joint Operations Command Project, Request for Tender AZ 3100, May 2005, clause 3.1(b), p. 5.

<sup>142</sup> *ibid.*, p. 2.

Specification.<sup>143</sup> The tender response evaluation methodology remained the same as that used for the responses to the RFT. Defence briefed tenderers on the significant divergences in their original tender responses to assist with the revision process. The RRO closed on 3 June 2005.

**3.40** Defence’s decision to change the structure and timing of the tender was consistent with the Commonwealth’s rights stated in the RFT. In terms of the tender evaluation process outlined in Figure 3.2, the TEB recommended a RRO stage and the PGB endorsed the change at a meeting held on 19 April 2005.<sup>144</sup> The Project’s Legal Process Adviser did not express any concern with the approach. The Minister noted on 29 April 2005 the outcome of the RFT evaluation, the proposed course of action, and the impact on timing for the delivery of the Project (see Table 3.2).

**3.41** Table 3.4 shows the responses received by Defence to the RRO, which invited the three shortlisted consortia to submit one or more revised offers, based on their original RFT response.

**Table 3.4**

**Tenderers’ responses to the HQJOC Request for Revised Offer AZ 3100 (issued 2 May 2005)**

Tenderer	Revised <sup>A</sup> Standard Tender Response	Revised <sup>A</sup> Alternative Tender Response	Non-conforming (rejected) Response
Prime Contractor	1	2	0
Consortium A	1	1	0
Consortium B	1	0	0

Note: (A) The tenderers’ RRO responses were based on their original RFT Standard and Alternative Tender Responses.

Source: ANAO analysis.

Compared to Table 3.3, Table 3.4 shows that the number of Alternative Responses to the RRO decreased by fifty per cent (from six to three responses)

<sup>143</sup> *ibid.*, p. 4. The RRO states at paragraph 2.6(d), on page 4, that: ‘Part 2 (of the RRO) contains amendments to the Project Deed and Schedules 2a, 2b, 2c and 4 of the Output Specification for the Project’.

<sup>144</sup> As a consequence of the tenderers’ RFT responses, the PCB was independently peer reviewed and revalidated. The resulting increased raw PCB was issued to the tenderers during the RRO stage. Chapter 2 describes the development of the PCB in detail.



as compared to the RFT. Defence advised respondents on 20 May 2005, that a revised ATR might be considered only if a revised STR was also submitted.

**3.42** The TEB held a series of meetings in late June 2005 to consider the evaluation reports prepared by the five Tender Evaluation Working Groups (TEWGs). The Source Selection Report (July 2005) for this stage contains a recommendation from the TEB to the PGB. The TEB recommended that Defence negotiate in parallel with the Prime Contractor and one other consortium—in order to be in a position to potentially recommend a preferred tenderer that would deliver a VFM solution—and that the third consortium be advised that its tender response would not be considered further. The PGB considered the TEB’s analysis at a meeting held on 6 July 2005 and endorsed the recommendations of the Source Selection Report, but noted that: ‘resolution of Project scope and Project cost is required before negotiations commence’.

#### *Revision of the Project’s scope and cost*

**3.43** Defence asked the Minister to note on 22 July 2005 that the RRO tender evaluation process had confirmed construction cost increases for the Project, originally identified during the RFT evaluation and after the Government approved the Project on 9 March 2004. Defence noted that a construction cost increase of \$39.12 million (2005–06 Budget prices outturned) could be absorbed within the approved Project’s cost by reducing the staffing of the facility from the originally proposed 1185 staff to 750 staff, with an associated reduction in facilities and site infrastructure also contributing to savings.<sup>145</sup> The HQJOC Project Office received advice from the Project’s Legal Process Adviser that a scope change, such as that described:

constitutes a material change to the Project’s Request for Tender which for reasons of procedural fairness will require the current tender evaluation

---

<sup>145</sup> The cost of the buildings and infrastructure component approved by the Government in March 2004 was \$227.0 million (2003–04 Budget prices outturned). A cost increase of \$39.12 million (2005–06 Budget prices outturned) would have resulted in an increase from \$238.72 million (cost updated to 2005–06 Budget prices outturned) to \$277.84 million (2005–06 Budget prices outturned).

recommendations to be put aside and all tenderers be invited to undertake a further revised offer tender process.<sup>146</sup>

### Review of the Australian Defence Force higher command and control structure

**3.44** After the PGB met on 6 July 2005, the DG HQJOC Project discussed the Project with the then Secretary, Department of Defence, and the Chief of the Defence Force (CDF) on 8 July 2005. The CDF had commissioned a review of the higher command and control structure of the ADF (the Review) in early July 2005. The outcomes from the high-level meeting on 8 July 2005 were conveyed to a PGB meeting held on 14 September 2005 as being to: revise the Project's cost for buildings and infrastructure, so as to remain within the Government's originally approved budget; and, to link any scope changes to the Review.

**3.45** Defence advised the Minister in July 2005 that, due to the increased time required for a fourth stage in the tender, the HQJOC Project Office had begun redrafting the tender documentation in July to incorporate the proposed scope change. The Minister was further advised that, if the Review determined a different outcome in staffing requirements from the staff reduction proposed by the scope change outlined in paragraph 3.43, and depending upon when the Review was finalised, the difference would be negotiated with the preferred tenderer prior to contract signature or via a contract variation post contract signature.

**3.46** On 14 September 2005 the Minister noted the advice from Defence that the Project's Legal Process Adviser considered that inviting all three tenderers to submit revised offers presented the least risk to the HQJOC tender, in terms of avoiding a challenge to the tender following the Project's change in scope. The Minister announced on 5 October 2005 that the outcome of the Review would be a reduction in the number of staff required for HQJOC from 1185 (the original ITR and RFT specification) to 750 staff.<sup>147</sup> The announcement included advice that the three shortlisted tenderers would be given an

---

<sup>146</sup> The advice was provided verbally in July and subsequently formalised by the Legal Process Adviser in a letter to the DG HQJOC Project dated 5 August 2005. Department of Defence, Minute, Office of the Deputy Secretary, DEPSEC CS/OUT/2005/171, *Headquarters Joint Operations Command Project Outcome of Tender Evaluation of Private Finance Component and Revised Project Scope – Interim Advice*, 22 July 2005, bullet point (e), p. 1.

<sup>147</sup> Department of Defence, Media Release 166/05, 5 October 2005, *ADF Headquarters to be streamlined* [Internet]. Defence, Canberra, 2005, available from <<http://www.defence.gov.au>> [accessed 11 June 2008].

opportunity to revise their tenders to take account of the changes to the HQJOC organisational structure and the facility's functional requirements.

**3.47** The PGB discussed the impact of the Review at its meetings held on 14 September and 18 November 2005. The DG HQJOC Project advised Board members that legal advice on the implications of the Review for the Project's tender had been sought and received from the Project's Legal Process Adviser, and the then General Counsel, DMO. The meeting minutes record that Board members were given a copy of the legal advices and asked to note that, on the basis of the advice, a decision was made to request the three consortia from the RRO stage to provide final revised offers.

#### **Stage 4: Request for Final Revised Offer (RFRO)**

**3.48** Defence issued a Request for Final Revised Offers (RFRO) to the tenderers on 24 October 2005, which closed on 19 January 2006.<sup>148</sup> Table 3.2 shows the impact of the RFRO stage on the tender schedule, including the change in timing for seeking Government approval for a preferred tenderer from 15 June 2005 (TEP V1-0) to March/April 2006 (TEP V3-0).

**3.49** The RFRO documentation advised tenderers that the outcome of the Review had impacted on the requirements for the HQJOC facility. Therefore, a final revised offer process was being offered as an opportunity for respondents to the RFT and RRO stages of the HQJOC tender to amend their tender responses in light of the changes to the Project's scope. The invited respondents were able to submit one or more final revised offers or decline to submit a final revised offer. Similarly to the RFT and RRO processes (see paragraphs 3.31 and 3.39), a tenderer was required to submit a STR and could choose to submit one or more ATRs. The form of the tender responses was to be based on addressing the issues identified in Defence's previous evaluation of each tenderers' RFT and RRO responses and taking into account the amended RFRO requirements. Defence's actions were in accordance with Section 2, 'Commonwealth Rights', paragraph 5.1 of the RFT.

#### *Change in the final tender closing date and payment of tenderers' costs*

**3.50** Defence debriefed the tenderers on their 5 June 2005 RRO responses from 12–13 October 2005 and provided a further briefing on 26 October 2005

---

<sup>148</sup> Defence also issued four Addenda to the RFRO.

after issuing the RFRO.<sup>149</sup> Defence initially advised the tenderers that the planned closing date for the RFRO would be 1 December 2005. However, the tenderers expressed concern that they would be unable to provide conforming, VFM responses within the proposed timeframe.

**3.51** Defence first advised the Minister on 17 October 2005 of the tenderers' concerns (followed by detailed advice on 8 November 2005) and sought the Minister's agreement to a revised tender close date for the RFRO of 19 January 2006.<sup>150</sup> The Minister agreed to extend the RFRO close date as recommended. Defence's advice also noted that a condition of participation in the RFRO given by two of the consortia was that the costs of their participation in the RFRO of the tender be covered in part or whole.<sup>151</sup> One of the tenderers advised Defence that it had incurred bid costs in excess of \$4 million leading up to the RFRO stage and expected the final tender stage to add another \$1 million to the cost of tendering for the Project.

**3.52** Defence provided advice on 14 November 2005 to the Minister about making a contribution to unsuccessful tenderers' responses to the RFRO. Defence's DPPM states that: 'When re-tendering is required, Defence will consider on a case by case basis, whether to meet reasonable costs incurred by those tenderers invited to re-tender.'<sup>152</sup> The Minister approved on 17 November 2005 a contribution from Defence of up to \$500 000 to each unsuccessful tenderers' RFRO response costs, subject to the tenderers satisfying a number of criteria in the DPPM and specific to the Project. The PGB meeting minutes from 18 November 2008 record that Defence informed the tenderers of the Minister's decision later in November 2005.

#### *Withdrawal of Consortium A from the tender*

**3.53** Defence advised the Minister on 8 November 2005 that there was a risk that one or more tenderers would withdraw from the tender if the timing for RFRO responses could not be extended. Consortium A wrote to Defence on

---

<sup>149</sup> The tenderers were advised that the RRO evaluation process had not resulted in a preferred tenderer being identified.

<sup>150</sup> The tenderers had agreed in discussions with the DG HQJOC Project in early November 2005 that 19 January 2006 would be an acceptable revised date for submission of RFRO responses.

<sup>151</sup> Both the RFT and RFRO documentation specify that a tenderer's participation in the tender process would be at their sole risk, cost and expense, including any termination, variation or suspension of the tender process. This approach was consistent with the DPPM.

<sup>152</sup> Department of Defence, op. cit., Section 5, Chapter 5.4, paragraph 446, p. 5.4.9.

14 November 2005 advising that as a condition the consortium had set for proceeding had not been met, which Defence was advised of on 27 October 2005—deferring the start of the RFRO to 2006—the consortium was formally withdrawing from the HQJOC tender. Defence had previously been discussing the matter with Consortium A and was aware of the consortium citing other work and project commitments impacting on the HQJOC tender’s timing as having contributed to the decision to withdraw.

**3.54** Defence advised the Minister of Consortium A’s withdrawal from the tender on 15 November 2005. Defence noted in the advice that Consortium A was ranked third after both the RFT and RRO evaluation processes in the VFM assessments, with the TEB recommending that the consortium be advised that its tender response would not be considered further at the end of the RRO stage (see paragraph 3.42).<sup>153</sup> Defence further advised that the withdrawal of one tenderer would shorten the RFRO evaluation process by one week, but would not diminish the competitiveness of the tender.

**3.55** As any payment to unsuccessful RFRO tenderers was to be made after financial close had been achieved for the Project, and by withdrawing Consortium A was ineligible for such a payment, Defence confirmed that none was made to the consortium. Defence further advised that, as a condition of their participation in the RFRO, tenderers were required to sign a Process Acceptance Deed. Defence advised the ANAO<sup>154</sup> that, as a consequence of the way in which Consortium B completed the Process Acceptance Deed in 2005, Defence later determined that the consortium was ineligible for any reimbursement of tender costs and no payment was made. At the time, Defence sought advice from the Project’s Legal Process Adviser.<sup>155</sup>

### *Final evaluation*

**3.56** Table 3.5 shows the two tender responses received by Defence to the RFRO.

---

<sup>153</sup> Defence advised Consortium A of the relative standing of its tender response as part of the RRO debriefing process in October 2005. However, the Tender Evaluation Board’s recommendation was set aside when the decision was made to proceed with the RFRO stage.

<sup>154</sup> Meeting between Defence and the ANAO on 3 November 2008.

<sup>155</sup> Defence letter to the ANAO dated 22 October 2008. Financial close for the Project was achieved on 28 July 2006. See Chapter 5 for details of the financial close.

**Table 3.5**

**Tenderers’ responses to the HQJOC Request for Final Revised Offer AZ 3206 (issued 24 October 2005)**

Tenderer	Final Revised <sup>A</sup> Standard Tender Response	Final Revised <sup>A</sup> Alternative Tender Response	Non-conforming (rejected) Response
Prime Contractor	1	3 <sup>B</sup>	0
Consortium B	1	0 <sup>C</sup>	0

Notes: (A) The tenderers’ RFRO responses were based on their RFT and RRO Standard and Alternative Tender Responses.

(B) The Prime Contractor’s ATR3 was later set aside from further consideration by the TEB on the grounds that it was not competitive against the Design and Construction evaluation criteria.

(C) Consortium B referred to two other options in its STR, but did not present the options in any detail or in the form of ATRs. The RFRO Returnable Schedules required that an ATR must be presented to a standard similar to that of a STR and address all of the information requested.

Source: ANAO analysis.

**3.57** Defence’s evaluation of the tenderers’ RFRO responses followed the same process outlined in the original RFT (see paragraph 3.32) and the two preceding versions of the TEP. Defence assessed the tender responses against five non-weighted evaluation criteria and the PCB. The aim of the RFRO tender evaluation was to produce a Source Selection Report containing a recommendation of a preferred tenderer that provided the: ‘best value for money in comparison with other tenders and which provides value for money superior to that represented by the Project Cost Benchmark’.<sup>156</sup>

*Source Selection Report*

**3.58** The TEB finalised a Source Selection Report (February 2006) for the RFRO at their ninth meeting held on 16 February 2006.<sup>157</sup>

**Net Present Cost of the tenderers’ responses**

**3.59** Apart from the Prime Contractor’s ATR3,<sup>158</sup> the Financial TEWG calculated the NPC of each of the tenderers’ responses using a discount rate of

<sup>156</sup> Department of Defence, op. cit., p. 18. (This quote is from the third and final version of the TEP.)

<sup>157</sup> The five TEWGs conducted the RFRO evaluation between 22 January 2006 and 12 February 2006 at the Barn, the same site used for the RFT and RRO evaluations.

<sup>158</sup> The Prime Contractor’s ATR3 involved a reduction in the Project’s scope and was later set aside from further consideration by the TEB on the grounds that it was not competitive against the Design and Construction evaluation criteria.

5.35 per cent (see paragraph 2.34 for an explanation of the discount rate). Table 3.6 presents a summary of the Financial TEWG's NPC calculations and final ranking, based on NPC and the tenderer's Financial Strength and Deliverability evaluation criteria.

**Table 3.6**

**Financial Tender Evaluation Working Group's Net Present Cost calculation and final ranking of tenderers' Request for Final Revised Offer responses, February 2006**

Tenderer's proposal <sup>A</sup>	Net Present Cost <sup>B</sup> (\$m)	Ranking (based on Net Present Cost)	Ranking (based on Financial Strength and Deliverability evaluation criteria)
Prime Contractor's STR	489.4	2	3
Prime Contractor's ATR1	491.3	3	1
Prime Contractor's ATR2	492.1	4	2
Consortium B's STR	470.1	1	3
<i>Commonwealth's risk adjusted Project Cost Benchmark</i>	496.2 <sup>C</sup>	-	-

Notes: (A) STR is Standard Tender Response and ATR is Alternative Tender Response.

(B) The NPC of insurance was removed as insurance costs are not included in the PCB. The NPC of tax was also removed from the PCB on the basis that it was considered to be a net benefit to the Commonwealth that offsets the costs of the Project. Defence also made a number of normalisation adjustments to the tenderers' responses to enable a 'like-for-like' comparison.

(C) Table 2.2 Chapter 2, shows that the raw PCB issued to tenderers with the Request for Final Revised Offer was \$319.5 million. The estimate of the risk adjusted PCB's NPC (\$496.2 million) was based on a 95 per cent confidence level, which meant there was a 95 per cent probability that the true value of the risk premium added to the raw PCB lay within the calculated lower and upper range.

Source: Department of Defence, Financial Tender Evaluation Working Group Final Report, February 2006, pp. 22, 37–38.

**3.60** Table 3.6 shows that Consortium B was ranked first by the Financial TEWG at the end of their assessment process, based on NPC alone, which was \$26.1 million less than the estimated risk adjusted PCB. However, in addition to the NPC assessment presented in the Financial TEWG's February 2006 report to the TEB, the report also states that:

[Consortium B's] STR bid is ranked first in NPC terms. It is essential to note that this bid proposes a stepped payment profile to the Commonwealth. If a flat payment structure was utilised by [Consortium B], the NPC of [Consortium B's] bid would increase by \$18 million, and would therefore

result in [Consortium B's] NPC being more closely aligned with the competing bids. This issue was noted with the Tender Evaluation Board Chair [the DG HQJOC Project] ... 1 February 2006.<sup>159</sup>

### Tender Evaluation Board's ranking of tenderers' final revised responses

**3.61** The TEB assessed that both of the remaining RFRO tenderers were capable of delivering the HQJOC facility.

**3.62** Apart from the Prime Contractor's ATR3, which was set aside (see Table 3.5 and footnote 158), the NPC of the other RFRO tender responses was assessed as below the risk adjusted PCB. Therefore, the Board considered each of the four remaining tender responses in undertaking its VFM assessment. Following consideration of final reports from the five TEWGs and a comparative assessment of the cost of the various tender responses compared to the PCB, the TEB ranked the RFRO responses on the basis of VFM to the Commonwealth as follows:

- [Prime Contractor's] ATR1 response: The Board assessed this tender could be entered into by the Commonwealth following negotiation on a small range of issues and represented the least risk to the Commonwealth;
- [Prime Contractor's] ATR2 response: The Board assessed this tender would require further legal documentation from [the Prime Contractor] (including a contingent equity guarantee)<sup>160</sup> and noted that it is not fully costed. The Board noted the advice of [the Project's Replacement Financial and Commercial Adviser] that Division 16D [of the *Income Tax Assessment Act 1936*]<sup>161</sup> is not a tried PPP solution in Australia for long term projects. The Board concluded that ATR2 is otherwise a developed tender response, which following negotiation could be entered into by the Commonwealth; and
- [Prime Contractor's and Consortium B's] STRs: The Board assessed that the Standard Tender Responses represented the highest risk to the Commonwealth. Of the two responses, the Board concluded that [Consortium B's] response represented the greater risk due to [Consortium B's] proposed risk pushback, program risk and the

---

<sup>159</sup> Department of Defence, Request for Final Revised Offers, Financial Tender Evaluation Working Group Report, February 2006, p. 36.

<sup>160</sup> See Chapter 5 for a discussion of the contingent equity guarantee referred to by the TEB.

<sup>161</sup> See Chapter 4 for a detailed discussion of the importance of the Project's taxation treatment.



uncertainty arising from its failure to provide marked-up Project documents. The Board also concluded that the lack of detailed marked-up Project documents would delay contract execution and impact on the delivery schedule if [Consortia B] was selected as the preferred tenderer.<sup>162</sup>

On the basis of the comparative Value for Money assessment the Board concluded that the [Prime Contractor's] ATR1 represents the best Value for Money tender response for the Commonwealth.<sup>163</sup>

**3.63** The TEB recommended to the PGB that the Project team negotiate with the Prime Contractor to resolve a number of outstanding issues on its ATR1, which the TEB considered represented the best VFM RFRO tender response for the Commonwealth.<sup>164</sup> The proposed negotiations were consistent with the Commonwealth's reserved rights under the RFRO. The TEB further recommended to the PGB that:

- noting the time period from Tender and Governance Board considerations until Government consideration (given the forthcoming budget cycle) that discussions be undertaken and if possible, concluded prior to Departmental and Government consideration in April 2006;
- [The Prime Contractor] be advised by the Project team that the discussions are intended to resolve outstanding issues with ATR1

<sup>162</sup> 'Risk pushback' refers to the TEB's assessment that Consortium B was seeking to transfer risks for the Project back to the Commonwealth, which Defence considered were better able to be managed by the private sector partner. The ability to transfer risk is a significant incentive for the public sector to engage in PPPs.

Initially, Defence considered that documents without mark-ups would reduce the time required for the evaluation and negotiation processes. However, 'marked-up Project documents' refers to a letter from the DG HQJOC Project dated 7 December 2005 advising both the Prime Contractor and Consortium B of a change to the RFRO to allow tender respondents to include mark-ups to the Project documents with their STR. As originally advised in the RFRO documentation, ATRs were able to include marked-up Project documents. The Prime Contractor provided marked-up documents and Consortium B provided a schedule of requested amendments and noted an intention to discuss matters further if they became the preferred tenderer.

Additionally, both tenderers' STRs were not capable of acceptance, in their current form, because of the uncertainty of their proposed taxation treatment (see Chapter 4 for details).

<sup>163</sup> Department of Defence, HQJOC Project Source Selection Report, February 2006, p. 11.

<sup>164</sup> *ibid.*, p. 12. The outstanding issues included:

- commercial matters, including risk apportionment;
- design improvements; and
- clarification of delivery of facilities management services.

prior to any decision by the Commonwealth on the selection of a preferred tenderer; and

- on completion of the discussions or if the discussions result in a proposed adjustment to the net present value of [the Prime Contractor's] tendered price for ATR1 to an amount which exceeds the risk adjusted PCB, the Project shall report the outcome to the Board.<sup>165</sup>

**3.64** The TEB's final Source Selection Report (February 2006) also stated that:

The Board noted that the net present cost of [Consortium B] delivering the Project is approximately \$21 million less than the net present cost of [the Prime Contractor] delivering the Project under its ATR1. The Board assessed that if [Consortium B's] tender was accepted the price differential with [the Prime Contractor's] ATR1 would be significantly reduced given the assessment of the risks associated with [Consortium B's] tender. The Board concluded that if the Commonwealth was to accept [Consortium B's] Final Revised Offer it would incur additional expenses, namely:

- Costs associated with Program acceleration in the order of \$6.5 million to \$8 million ([Consortium B's] proposed Project schedule commences early March 2006 which the Commonwealth is unable to meet and accordingly [Consortium B] is likely to increase its tendered price on this account); and
- Costs associated with 'risk pushback' to the Commonwealth identified in [Consortium B's] notations on the Project documentation which have been identified, however it is not possible to fully quantify such costs in the absence of detailed mark-ups from [Consortium B] to the Project documentation.<sup>166</sup>

Project Governance Board deliberation

**3.65** The PGB considered the Source Selection Report, including the TEB's recommendation, and received presentations from the five TEWGs at a meeting held on 16 February 2006. After discussing the RFRO process to date, the PGB resolved the following main points:

- **noted and accepted** the TEB's Value For Money assessment and the rankings of tender responses as presented;

---

<sup>165</sup> *ibid.*

<sup>166</sup> *ibid.*, pp. 10–11.

- **noted and did not agree** with the TEB's recommendation to undertake discussions with [the Prime Contractor] on its ATR1 ahead of proceeding to Government; and
- **noted and agreed** the proposed timetable for proceeding to Government.<sup>167</sup>

The PGB also directed the HQJOC Project Office to perform a series of administrative tasks, including consultation with other agencies, before the proposed consideration of the Project by the Government in April 2006.

## Post-tender activities

### *Evaluation of the tender process*

**3.66** The HQJOC tender's *Process Plan*, prepared by the Project's Legal Process Adviser, states that the adviser will report and sign-off to the DG HQJOC Project at the end of the Project on the Project's level of compliance with relevant probity requirements. The final *Legal Process Adviser's Report* on the Project is dated 3 January 2007 and sets out the Legal Process Adviser's involvement in the Project, including matters on which advice was provided to Defence (see Chapter 7 for a discussion of two significant probity matters that arose during the audit). The report notes that the adviser provided a detailed legal process and probity sign-off for the ITR of the HQJOC tender on 15 September 2004, and a similar report for the RFT, RRO and RFRO on 27 June 2006.

**3.67** In the summary, the *Legal Process Adviser's Report* concludes that, based on the role required and in the view of the Legal Process Adviser, the Project was conducted according to the *Process Plan* and, as far as the adviser was aware, was conducted in a manner consistent with legal process and probity requirements. Furthermore, as far as the adviser was aware, the evaluation processes for the HQJOC tender had followed the evaluation methodology described in the TEPs and also advised to the tender respondents for the RFT, RRO and RFRO.

**3.68** At the request of the HQJOC Project Office, the Project's Risk Management Adviser undertook an audit in August 2006 of the Project's procurement process and produced a report titled *Audit of Procurement Process*

---

<sup>167</sup> Department of Defence, HQJOC Project Governance Board Meeting Record No.9, 16 February 2006, Agenda item 10.0, 'Project Governance Board Considerations', p. 5.

for the Headquarters Joint Operations Command Project dated February 2007. The audit sought to determine the extent to which Defence had complied with relevant Australian Government, Defence and HQJOC Project procurement policies and processes, such as the *Commonwealth Policy Principles for the use of Private Financing* and the DPPM (Version 5). In summary, the audit found that there was a high level of assurance that Defence had complied with the relevant policies and procedures and that the procurement process was appropriate to ensure that the Commonwealth achieved a VFM outcome from the HQJOC tender.

### ***Debriefing the tenderers***

**3.69** It is a requirement of the CPGs that agencies promptly inform tenderers of the outcome of a tender and, on request, debrief unsuccessful tenderers on the reasons their tender response was not successful. Agencies can also debrief successful tenderers, on request.<sup>168</sup> The TEP for the RFRO advises that the unsuccessful tenderers will be notified and offered an opportunity to receive a verbal debrief from Defence based solely on the evaluation of their respective individual tender responses. The debriefings were to be offered after financial close had been achieved for the Project, which took place in late July 2006.

**3.70** Defence held a debriefing meeting with Consortium B on 20 October 2006 in Canberra and Consortium A on 23 October 2006 in Sydney. Defence also met with the Prime Contractor for a debriefing meeting on 1 December 2006 in Sydney. Records maintained by Defence show no issues were raised by the consortia during the debriefing meetings that would have affected the outcome of the Project's tender had they been raised earlier during the live tender by one of the tenderers.

---

<sup>168</sup> Department of Finance and Administration, op. cit., p. 21.

## 4. Decision on Preferred Tenderer

---

*This chapter discusses Defence's implementation of the Government's decision on a preferred tenderer for the HQJOC Project and, in particular, the importance of the Project's tax treatment.*

### Introduction

**4.1** Following on from the completion of the tender evaluation process discussed in Chapter 3, this chapter covers the period in the Project from immediately after the Government's decision on 26 April 2006 selecting a preferred tenderer for the Project. A central feature of implementing the Government's decision was for Defence to determine the most effective whole of government tax treatment for the Project as part of ensuring the PPP arrangement delivered VFM.

### Implementing the Government's decision on the preferred tenderer for the Project

**4.2** On 26 April 2006 the Government considered a Cabinet Submission from Defence that sought agreement to the Prime Contractor being selected as the preferred tenderer for the Project. Defence's Submission discussed the tenderers' RFRO responses and presented the TEB's assessment and ranking, with the Prime Contractor's ATR1 ranked first, based on cost and risk analysis (see paragraph 3.62). Defence also sought agreement that the Project could proceed under PPP arrangements, on the basis that Defence had (using the PCB as a central evaluation tool) demonstrated better VFM to be delivered by a PPP than the alternative of Defence proceeding using direct procurement to design, construct, finance, operate and maintain the HQJOC facility. Defence estimated that if a decision was made at that point to use direct procurement, then the Project would be delayed by up to 12 months.

### 4.3 The HQJOC TEB meeting minutes from 29 May 2006 record that:

[The] Government agreed to the recommendation of the selection of [the Prime Contractor] as preferred tenderer, but not on the basis of its ATR1 (securitised lease)<sup>169</sup> but rather its STR (Division 250 of the *Income Tax Assessment Act 1936* (Cth)), and left it to:

- a. the Treasurer, Minister for Finance and Administration and the Minister for Defence to settle the taxation model to be used; and
- b. the Minister for Finance and Administration and the Minister for Defence to settle the financial implications of this approach.<sup>170</sup>

## Importance of the tax treatment

### PPP policy context for tax

4.4 The *Commonwealth Policy Principles for the Use of Private Financing* (2002) highlight the importance of considering the potential whole of government implications of tax revenue from PPPs—rather than just the impact at an individual agency level.<sup>171</sup> If the private sector is able to maximise the tax benefits from a PPP, this could result in the Commonwealth foregoing expected tax revenue. The policy principles suggest that agencies identify any tax implications and develop strategies for managing and/or accounting for the proposed tax treatment for a PPP as part of the VFM calculations.

4.5 In advice to the DG HQJOC Project dated 6 February 2006, Finance emphasised the need for Defence’s HQJOC Financial TEWG to assess the

---

<sup>169</sup> The Project’s Legal Adviser on 11 May 2006 provided Defence with an analysis of the taxation treatments contained in the tenderers’ RFRO responses. A ‘securitisation’ structure was described as follows:

In a ‘securitisation’ structure the private sector participant does not take ownership of the PPP asset. Instead, the cashflows that relate to the ownership of the asset are diverted, assigned or novated (for a price) to a private sector participant that in turn uses them as security to raise finance. There are no tax benefits and therefore the [tax] rules described above should not apply [section 51AD, Division 16D and proposed Division 250 of the *Income Tax Assessment Act 1936* (see paragraphs 4.7 and 4.13 for details)].

The Legal Adviser also stated that:

The ‘securitisation’ approach produces a certain and acceptable tax outcome (supported by private binding tax rulings), but we understand may be seen as requiring Commonwealth participation in an artificial or contrived structure.

<sup>170</sup> HQJOC Project Tender Evaluation Board Meeting No. 9, 29 May 2006, Agenda Item 6.1, p. 2.

<sup>171</sup> Department of Finance and Administration, op. cit., p. 13.

tender responses on a whole of government basis, in accordance with the policy principles' guidance on tax treatment.<sup>172</sup> Defence subsequently explained the approach taken by the Financial TEWG to assessing the tenders and Finance indicated via email on 22 February 2006 that the approach to the tax analysis was acceptable.

## Private sector versus government approach to tax for PPPs

**4.6** The possibility of tax benefits is one of the benefits that makes PPPs attractive for private sector investors. A long term arrangement enables the private sector investor to defer tax payments by changing the profile of taxable income over the life of the arrangement as follows:

A typical situation was the existence of tax losses in the early years of an arrangement created by deductions for depreciation and other capital allowances (such as investment allowance) being greater than income from the property. The taxpayer could use these losses to offset assessable income from other sources. While income in later years might exceed allowable deductions, in present value terms the arrangement was tax advantaged.<sup>173</sup>

**4.7** From the Commonwealth's perspective, the approach described in paragraph 4.6 could be partially offset by the private sector investor passing back part of the tax benefit to its government agency partner through lower finance charges, resulting in lower cost to use the relevant property. However, at the time the tender process for the Project was conducted the Government had also enacted legislation to limit private sector participants' access to tax benefits.<sup>174</sup> The *Income Tax Assessment Act 1936* (ITAA 1936) contains two sections on leasing that impacted directly on PPPs at that time. The sections referred to in the ITAA 1936 as anti-avoidance provisions are: Section 51AD Deductions not allowable in respect of property used under certain leveraged arrangements; and, Division 16D Certain arrangements relating to the use of property. Figure 4.1 provides a brief description of these tax arrangements.

---

<sup>172</sup> While the Financial TEWG took into account the impact of the taxation treatment, in terms of the overall VFM calculation, the detailed evaluation of tenderers' responses to the taxation arrangements sub-criteria in the RFRO was undertaken by the Commercial TEWG.

<sup>173</sup> New Business Tax System (Tax Preferred Entities – Asset Financing) Bill 2003, Explanatory Material, paragraph 1.10, p. 7.

<sup>174</sup> *ibid.*, paragraph 1.11, p. 7.

## Figure 4.1

### **Income Tax Assessment Act 1936: anti-avoidance provisions for leasing**

**Section 51AD Deductions not allowable in respect of property used under certain leveraged arrangements:** deals with leveraged leases and similar arrangements over property financed predominantly by non-recourse debt.<sup>175</sup> It seeks to deny tax deductions for interest, depreciation and other capital allowances on capital expenditure incurred by owners of property where the end user does not earn assessable income (for example, a tax exempt State government entity or a non-resident not deriving Australian sourced income). The provision can apply where the end user is a lessee or where it has effective control of the property.

**Division 16D Certain arrangements relating to the use of property:** deals with certain non-leveraged finance leases and comparable arrangements. It provides that income tax deductions are not allowable to the owner of property in respect of capital expenditure incurred on the property where it is subject to certain finance leases or similar arrangements. It applies where the end user is a tax exempt entity which uses and controls the use of the property owned by a taxable entity. Where Division 16D applies, the finance lease or similar arrangement is in effect treated as a loan arrangement and the payments made under it as having principal and interest components.

Source: New Business Tax System (Tax Preferred Entities – Asset Financing) Bill 2003, Explanatory Material, p. 5.

## **Defence's position on tax for PPPs**

4.8 Defence's *Private Financing Manual* 2002 discussed the issues surrounding private financing structures and the implications for tax, including the possibility of savings for the agency at the expense of foregoing whole of government tax revenue. The manual concluded that the preferred approach for Defence was to use contract provisions in PPPs that would trigger the application of Division 16D of the ITAA 1936.<sup>176</sup>

## **Proposed tax treatment for the HQJOC Project**

4.9 The HQJOC Project Office acted consistently with the *Private Financing Manual* advice referred to in paragraph 4.8 and wrote to the Australian Taxation Office (ATO) in the early stages of the Project in December 2004 seeking advice. The Project Office advised the ATO that Defence intended to

---

<sup>175</sup> Non-recourse debt is: 'one where the lender's rights against the borrower in the case of default in repayment are effectively limited to rights against the property, or against income generated or goods produced by the property'. See Taxation Ruling TR 96/22 for further details. Parliament of Australia, Research Paper No. 1, *Public Private Partnerships: An Introduction*, Parliamentary Library, 2002–03, p. 11.

<sup>176</sup> Department of Defence, op. cit., pp. 24–27.



ask the bidding consortia, as part of the tender process, to seek a private binding ruling from the ATO for their proposed tax treatment and requested an Administratively Binding Advice for Defence regarding the possible application of Division 16D to the Project.

**4.10** The ATO replied to the HQJOC Project Office in February 2005 in the form of a 'Notice of Administratively Binding Advice. Authorisation Number: 49673'. The notice advised that Division 16D of the ITAA 1936 would be likely to apply to the proposed arrangement (being a 30 year lease period starting after the completion of the building), although the advice was subject to a qualification that insufficient information was available to determine the operation of relevant sections of Division 10D Property. (See Chapter 5 for discussion of a tax ruling as a Condition Precedent for the Project.)

### **Defence's advice on tax to the tenderers**

**4.11** Defence advised tenderers of the minimum required content their tender responses were to address for tax arrangements in Returnable Schedule E3 'Taxation arrangements' in the RFT, RRO and RFRO stages of the tender. Essentially, the same advice was provided at each stage of the tender. The tax arrangements sub-criterion addresses: 'The efficacy of the Tenderers' proposed taxation position and the impact of this position on Project deliverability'.<sup>177</sup> The sub-criterion advised that:

Tenderers should note:

The Commonwealth acknowledges that the proposed changes to the taxation laws governing the treatment of private financing arrangements, particularly the proposed Division 250 of the *Income Tax Assessment Act 1997*, may present some complexity for Tenderers. Tenderers should note that the Commonwealth will give favourable consideration to bids that are certain and not conditional upon the timing of or enactment of legislation or obtaining favourable taxation rulings.<sup>178</sup>

**4.12** Defence's Commercial TEWG summarised the risk and options available to tenderers as a result of the proposed introduction of Division 250 and repeal of section 51AD as follows:

---

<sup>177</sup> Department of Defence, Headquarters Joint Operations Command Project RFT AZ 2931, Returnable Schedules, September 2004, p. 71.

<sup>178</sup> Returnable Schedule E3, Subcriterion 'Taxation arrangements', Request for Final Revised Offers (RFRO) AZ 3206 (6 December 2005), p. 78.

- assume that section 51AD will apply to the Project and modify the structure to avoid its operation (at a cost);
- assume that proposed Division 250 will apply to the Project; or
- put forward a transaction structure that avoids the operation of section 51AD, proposed Division 250 and the latter's current counterpart—Division 16D.<sup>179</sup>

## Proposed Division 250 tax legislation

**4.13** An Exposure Draft of the New Business Tax System (Tax Preferred Entities—Asset Financing) Bill 2003 was released by the then Minister for Revenue and Assistant Treasurer Senator the Hon. Helen Coonan on 26 June 2003. The proposed reform entailed replacing section 51AD and Division 16D of Part 111 of the ITAA 1936 with a new Division 250 in the ITAA 1997, to improve the tax framework for PPP asset financing arrangements. The Minister and Assistant Treasurer announced a temporary deferral of the proposed legislation on 4 December 2003 after the Government received numerous submissions on the Exposure Draft that: 'raised varied and sometimes conflicting issues about key parameters of the proposed reforms'.<sup>180</sup>

**4.14** On 13 September 2005, the then Minister for Revenue and Assistant Treasurer, Mal Brough, issued a related media release titled 'Tax Exempt Asset Financing Reforms', which outlined proposed changes to the tax treatment of financing arrangements for PPPs.<sup>181</sup>

**4.15** However, it was August 2007 before the Government introduced the new Bill to restrict the operation of section 51AD and Division 16D of the ITAA 1936 to arrangements entered into before 1 July 2007.<sup>182</sup> In their place a proposed Division 250 ITAA 1997 would institute arrangements for taxing the

---

<sup>179</sup> HJOC Project Commercial Tender Evaluation Working Group Report, Final Revised Offers, p. 12.

<sup>180</sup> The Treasury, Media Release C115/03, 'More time to finalise asset financing reforms' [Internet]. Minister for Revenue and Assistant Treasurer, Canberra, 4 December 2003, available from, <<http://assistant.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=pressreleases/2003/115.htm&min=hlc>> [accessed 22 February 2008].

<sup>181</sup> Available from <<http://treasurer.gov.au>> [accessed 23 June 2008].

<sup>182</sup> The Bill proposed that the older legislation (section 51AD and Division 16D of the ITAA 1936) would remain in the ITAA 1936, but would be limited to agreements entered into before 1 July 2007. Department of Parliamentary Services, Bills Digest No.42, *Tax Laws Amendment (2007 Measures No.5) Bill 2007*, Parliamentary Library, Canberra, 2007, p. 17.

proceeds of leases or other arrangements for the use of assets by tax preferred entities, such as the Commonwealth. The *Tax Laws Amendment (2007 Measures No. 5) Act 2007* received Royal Assent on 25 September 2007 and Division 250—Assets put to tax preferred use, is incorporated in the ITAA 1997. The introduction of Division 250, after Defence reached commercial close with the Prime Contractor on 30 June 2006, has not altered the Project’s tax treatment.

## Tenderers’ tax responses

**4.16** After the ITR stage of the tender (described in Chapter 3), the tenderers submitted responses to three further rounds in the tender. Table 4.1 shows the tenderers, the tender round and the tenderers’ approach to Defence’s request to address tax arrangements in their responses.

**Table 4.1**

### Tenderers’ proposed tax arrangements during the tender process

Tender stage	Prime Contractor	Consortium A	Consortium B
Request for Tender	<p><u>STR</u><sup>A</sup> – s. 51AD</p> <p><u>ATR1</u><sup>B</sup> – securitised lease structure (similar tax outcome to Division 16D and proposed Division 250)</p> <p><u>ATR2</u> – securitised lease structure (similar tax outcome to Division 16D and proposed Division 250)</p> <p><u>ATR3</u> – securitised lease structure (similar tax outcome to Division 16D and proposed Division 250)</p>	<p><u>STR</u> – Licencing structure (avoids the operation of section 51AD, ITAA 1936)<sup>C</sup></p> <p><u>ATR1</u> – Licencing structure (avoids the operation of section 51AD, ITAA 1936)</p> <p><u>ATR2</u> – Licencing structure (avoids the operation of section 51AD, ITAA 1936)</p>	<p><u>STR</u> – Proposed Division 250</p> <p><u>ATR1</u> – Proposed Division 250</p>

Tender stage	Prime Contractor	Consortium A	Consortium B
Request for Revised Offer	<p><u>STR</u> – Division 16D</p> <p><u>ATR1</u> – securitised lease structure (similar tax outcome to Division 16D and proposed Division 250)</p> <p><u>ATR2</u> – securitised lease structure (similar tax outcome to Division 16D and proposed Division 250)</p>	<p><u>STR</u> – Licencing structure</p> <p><u>ATR1</u> – Licencing structure</p>	<p><u>STR</u> – Proposed Division 250</p>
Request for Final Revised Offer	<p><u>STR</u> – Proposed Division 250</p> <p><u>ATR1</u> – securitised lease structure (similar tax outcome to Division 16D and proposed Division 250)</p> <p><u>ATR2</u> – Division 16D</p> <p><u>ATR3<sup>D</sup></u> – (reduced scope only)</p>	<p>Withdrew from the tender at this stage.</p>	<p><u>STR</u> – Proposed Division 250</p>

Notes: (A) STR: Standard Tender Response.

(B) ATR: Alternative Tender Response.

(C) Use of a licence structure, rather than a lease structure, would have avoided the operation of section 51AD, ITAA 1936.

(D) As discussed in Chapter 3, the Prime Contractor's ATR3 was later set aside from further consideration by the TEB on the grounds that it was not competitive against the Design and Construction evaluation criteria.

Source: ANAO analysis, based on advice from Defence sent to the ANAO in December 2008.

**4.17** The ANAO found that only the Prime Contractor received written advice from Defence on its proposed tax treatment outlined in its RFT tender responses. Defence advised the Prime Contractor that: 'The Commonwealth suggest the Respondent reconsider the tax arrangements of Section 51AD in the development of any Revised Offer.' Other than the advice referred to in paragraph 4.11—namely that: 'the Commonwealth will give favourable consideration to bids that are certain and not conditional upon the timing of or enactment of legislation or obtaining favourable taxation rulings'—Defence did not provide further written advice to Consortium A or B in subsequent rounds of the tender.

**4.18** The Prime Contractor included the following advice in its RFRO response to Schedule E3.1a Taxation Arrangements:

[The Prime Contractor] submitted in its original February 2005 RFT Offer as a standard bid a proposal that assumed that section 51AD of the *Income Tax Assessment Act 1936* applied to [the Prime Contractor]. While [the Prime Contractor] remains willing and able to revert to the original assumption that section 51AD will apply, in light of the Commonwealth's advice in its RFRO, [the Prime Contractor] has not submitted a structure option in this RFRO on this basis. Instead, this RFRO refines and updates the options set out in the June 2005 RRO.<sup>183</sup>

**4.19** At the RFRO stage, Defence also advised the tenderers that it would be a Condition Precedent in the Project Deed that the preferred tenderer seek a private binding ruling from the ATO for the Project's final tax arrangement.<sup>184</sup> The Prime Contractor notified Defence by letter on 20 April 2006 that it had received a private binding ruling from the ATO relating to its ATR1 submitted on 19 January 2006. The letter advised that the ruling was favourable and validated the tax assumptions in the Prime Contractor's ATR1. Consortium B did not obtain a private binding ruling from the ATO at that time.

### **Impact of proposed Division 250 on the tender evaluation process**

**4.20** Table 4.1 shows that both the Prime Contractor and Consortium B based their STR for the RFRO on the proposed Division 250 amending the ITAA 1997. When the Commercial TEWG conducted its final evaluation of the tenderers' tax arrangements in their RFRO responses, the TEWG decided that:

There is a material risk that this assumption [proposed Division 250 will apply to both tenderers' STR] will not prove valid. ... Having regard to this risk we believe it would be advisable to approach the two bidders' proposals on the basis that their Standard Response cannot be implemented. We therefore need to analyse their alternative responses.<sup>185</sup>

**4.21** As discussed in Chapter 3, and highlighted again in Table 4.1, Consortium B did not provide a compliant ATR at either the RRO or RFRO

<sup>183</sup> Praeco Tender No. AZ 3206 response, Section E: Commercial, 19 January 2006, p. 4.

<sup>184</sup> A condition precedent in contract law is a provision of a contract that suspends the coming into effect of a contract or a term of the contract unless or until a certain event takes place.

<sup>185</sup> HQJOC Project Commercial Tender Evaluation Working Group Report, Final Revised Offers, Schedule D – Tax Assessment Report, v1.2, 14 February 2006, p. 150.

stages. The ANAO noted that Consortium B offered instead that, if during the preferred tenderer stage proposed Division 250 had not been realised, an alternative tax arrangement could be offered to Defence without changing the total cost of the tender response.<sup>186</sup> However, the structural solutions were not presented as ATRs and lacked sufficient detail for further consideration by Defence.

**4.22** Table 4.2 presents the Commercial TEWG’s RFRO overall ranking of the tenderers’ responses. The commercial evaluation concluded that the preferred tender response was the Prime Contractor’s ATR1, based on a securitised lease structure.

**Table 4.2**

**Commercial Tender Evaluation Working Group ranking of Request for Final Revised Offer Tender Responses**

Tender response	Taxation structure rank	Overall ranking <sup>A</sup>
Consortium B STR <sup>B</sup>	3	3
Prime Contractor’s STR and ATR3 <sup>C</sup>	4	4
Prime Contractor’s ATR1	1	1
Prime Contractor’s ATR2	2	2

Notes: (A) The overall ranking also includes an assessment of risk divergence and commercial structure.

(B) STR: Standard Tender Response.

(C) ATR: Alternative Tender Response. As discussed in Chapter 3, the Prime Contractor’s ATR3 was later set aside from further consideration by the TEB on the grounds that it was not competitive against the Design and Construction evaluation criteria.

Source: HQJOC Project Commercial Tender Evaluation Working Group Report, Final Revised Offers, v1.2, 14 February 2006, p. 14.

**4.23** The TEB Source Selection Report, February 2006, includes the following analysis of the Prime Contractor’s RFRO tender responses:

- the STR, which is structured on the assumption that Division 250 of the *Income Tax Assessment Act [1997]* will apply to the Project, could not be entered into by the Commonwealth in its present form given

<sup>186</sup> Consortium B offered a structural solution in the form of either: a contingent equity or guarantee structure; or a lease and leaseback structure. The Commercial TEWG’s RFRO Final Report, v1.2, 14 February 2006, Schedule D, observes that, from a taxation perspective, both the Prime Contractor’s and Consortium B’s alternative responses are similar and they both received taxation advice from the same accounting firm, paragraph 7, p. 150.

the uncertainty surrounding the introduction of Division 250 and if introduced, whether this Division would apply to the Project;

- the ATR1 Securitised Lease Structure, being fully costed, supported by a financial model and documented could be entered into by the Commonwealth, subject to the satisfactory resolution of proposed divergences to the Project documents and the addressing of various issues identified by the TEWGs; and
- the ATR2 Division 16D, which is not fully costed and documented (contingency equity not fully costed and documented), could be entered into by the Commonwealth, subject to the satisfactory resolution of proposed divergences to the Project documents and the addressing of various issues identified by the TEWGs, including the provision of a contingent equity guarantee.<sup>187</sup>

**4.24** The ANAO noted in Chapter 3 that none of the evaluation criteria—including the tax arrangements sub-criterion—were weighted or assigned a priority in the TEP. Furthermore, Defence’s assessment of the Prime Contractor as preferred tenderer was based on an assessment of the conclusions from all five TEWGs and not solely on Defence’s assessment of the certainty of the tenderers’ proposed tax arrangements.

## Summary

**4.25** The ANAO’s analysis identified a number of benefits and limitations in Defence’s approach to the tax treatment during the tender, which are presented in Figure 4.2.

---

<sup>187</sup> See Chapter 5 for a discussion of the contingent equity guarantee. Department of Defence, *op. cit.*, pp. 9–10.

**Figure 4.2**

**Benefits and limitations of Defence’s approach to the HQJOC Project’s tax treatment**

<u>Benefits</u>	<u>Limitations</u>
<ul style="list-style-type: none"><li>• Consistent advice from Defence, with limited variation between tender stages, provided certainty for the tenderers.</li><li>• Less cost for tenderers—not required to obtain new advice at each stage of the tender.</li><li>• Comparable evaluation approach for Defence between each stage of the tender.</li></ul>	<ul style="list-style-type: none"><li>• Limited variation in tender documents and little/no feedback from Defence between tender stages could be seen as implicit agreement by Defence that the tenderers’ approach was acceptable to Defence (including relying on proposed legislation).</li><li>• Uncertainty of the proposed tax legislation resulted in a focus on this issue as a critical differentiator between the tenderers.</li></ul>

Source: ANAO analysis.

**4.26** Defence provided Consortium B with the same advice as the Prime Contractor about the format required for the STR and any ATRs. The two consortia proposed similar structures for their STR tax arrangements. The ANAO considered that it was possible that ‘bidder fatigue’ after four stages of the tender, or the perception that there was an implicit acceptance of their approach, based on Defence’s lack of feedback between stages of the tender, resulted in Consortium B’s approach to the RFRO (a STR only and no ATR options).

**4.27** It is clear from the Prime Contractor’s and Consortium B’s tender response documentation that both were aware of the proposed Division 250 legislation and its status. Defence also provided consistent advice in the tender documentation about proposed Division 250 from the RFT issued in September 2004 through to the close of the RFRO in January 2006. However, it is not clear why Defence, with advice from Treasury, could not have formed the view in October 2005 when the RFRO was issued—that it later did in January and February 2006 when the RFRO tender responses were evaluated—that any tender response based on Division 250 could not be entered into by the Commonwealth at that time, given the uncertainty surrounding the introduction of the proposed legislation and its potential application.

**4.28** Defence advised the PGB at a meeting held on 16 February 2006 that it had sought advice from Treasury on the matter, but had not received a response at that time. The PGB also noted Defence’s advice that uncertainty about the Project’s tax arrangements, should a tender response based on the proposed Division 250 of the ITAA 1997 be selected, posed a risk for the



Commonwealth. If legislative changes negatively impacted on the successful tenderer at a later date, that could necessitate renegotiation of the contract.

**4.29** The PGB minutes record that Defence sought advice from Treasury a second time on the timing for the introduction of the proposed Division 250 and received a response on 17 February 2006 and circulated the advice to PGB members on that day. Treasury's advice was that the intention was for the Treasurer to introduce a Bill for Division 250 into Parliament in 2006 and work towards full passage of the legislation, including Royal Assent, by the end of 2006.<sup>188</sup> This proposed timetable meant that it was unlikely that there could be any certainty that Division 250 would be applicable to the HQJOC Project given that at this point, in February 2006, Defence was looking to complete financial close with a preferred tenderer by June 2006.

**4.30** Once the tender responses were received, and an approach to the evaluation of the tenderers' tax structures had been settled by the Commercial TEWG, this effectively left only the Prime Contractor with viable tender responses that could be entered into by Defence and positively presented to the Government.

### **Consortium B's Standard Tender Response**

**4.31** As previously discussed, both the Prime Contractor's and Consortium B's STRs were based on the introduction of proposed Division 250 into the ITAA 1997. Notwithstanding Defence's advice that both tenderers' STRs were not capable of acceptance, in their current form, because of the uncertainty of their proposed tax treatment, the Government selected the Prime Contractor's STR as the preferred tender response for negotiation going forward. Following this decision of the Government, Defence did not hold further discussions with Consortium B about its STR for the reasons outlined in the following section.

#### *Basis for no further negotiation with Consortium B*

**4.32** As discussed in detail in Chapter 3, (see paragraphs 3.62 and 3.64) Defence assessed that the margin of cost difference between the two tenderers would be significantly reduced when the risks associated with Consortium B's STR were fully quantified for:

---

<sup>188</sup> However, the relevant Bill did not in the end receive royal assent until 25 September 2007 and applies to arrangements entered into after 1 July 2007 (see paragraph 4.15).

- costs associated with Program acceleration in the order of \$6.5 million to \$8 million; and
- costs associated with 'risk pushback' to the Commonwealth identified in Consortium B's annotations on the Project documentation that were unable to be fully quantified without further detail being available.

**4.33** Defence had previously assessed in February 2006 that the NPC of Consortium B's STR (\$470.1 million) was \$26.1 million less than the risk adjusted NPC of the PCB (\$496.2 million) and \$19.3 million lower than the NPC of the Prime Contractor's STR (\$489.4 million).

**4.34** Defence's TEB also concluded that the lack of detailed marked-up Project documents would delay contract execution and impact on the delivery schedule if the Government were to select Consortium B as the preferred tenderer.

**4.35** The subsequent Minutes of the 29 May 2006 meeting of the TEB record that:

[Consortium B] was not asked to clarify its position as HQJOC Project and advisers formed the view that the expense and commitment of time which would have been required by it to participate in the process was not justified given the current standing of their bid.

**4.36** However, Defence retained the ability to negotiate with Consortium B until such time as the preferred tenderer was announced and if discussions with the Prime Contractor were unsatisfactory.

#### *No probity matters arising from negotiation phase*

**4.37** In the negotiation phase of the Project, the Project's *Process Plan* states that, from a probity perspective:

If the negotiations result in a material change either to the preferred tenderer's bid or to the Project specifications or other requirements, Defence should consider whether it should give other bidders the opportunity to revise their bids'.<sup>189</sup>

**4.38** As discussed in Chapter 3, the Project's Legal Process Adviser monitored Defence's activities during the tender evaluation stages against the

---

<sup>189</sup> Australian Government Solicitor, *Headquarters Joint Operations Command Project Process Plan*, April 2004, p. 13.

requirements contained in the Project's *Process Plan* and did not identify any probity concerns during the Project's negotiation phase.

### **Defence's consultation on the tax treatment with the Prime Contractor, Finance and Treasury officials**

**4.39** As discussed in paragraph 4.3, the Government selected the Prime Contractor's STR in April 2006 and requested that the Treasurer, the Minister for Finance and Administration, and the Minister for Defence settle the taxation model to be used and the financial implications of that approach. Defence advised the ANAO in November 2007 that:

On 8 May 2006, the Secretary Department of Defence advised the Minister – the details and quantum of the tax issue had yet to be settled, but these would be handled as part of the contractual negotiations which would follow, in the normal way, the selection of the preferred tenderer.<sup>190</sup>

**4.40** The Minister for Defence agreed on 12 May 2006 to the HQJOC Project Office holding clarifying discussions with the Prime Contractor, as the preferred tenderer, on the proposed handling of the tax treatment. Defence held a series of meetings in May 2006 with the Prime Contractor and separately with officials from Treasury and Finance to discuss the implementation of the Government's decision, as follows:

- **16 May 2006**—Defence held clarifying discussions with the Prime Contractor;
- **19 May 2006**—the DG HQJOC Project, accompanied by the Project's Legal Adviser and Replacement Financial and Commercial Adviser met with officials from Treasury and Finance;
- **22 May 2006**—Defence held clarifying discussions with the Prime Contractor;
- **24 May 2006**—the DG HQJOC Project met again with Treasury officials; and

---

<sup>190</sup> Letter from Defence to the ANAO dated 21 November 2007.

- **26 May 2006**—Defence held clarifying discussions with the Prime Contractor.<sup>191</sup>

**4.41** Prior to the start of the clarifying discussions, the Project's Legal Adviser provided detailed written advice to Defence dated 11 May 2006 on the tax aspects of financing structures for the Project. The Legal Adviser concluded that if the Prime Contractor's STR was not able to proceed because the Commonwealth's condition could not be met—enacting proposed Division 250 in legislation—then Defence should seek to put in place a finance lease structure with the Prime Contractor.

**4.42** Defence informed the Minister for Defence on 25 May 2006 that a letter dated 12 May 2006 was sent to the Prime Contractor proposing clarifying discussions be held, including the position in relation to the Prime Contractor's STR assumption that Division 250 will apply to the Project (see paragraph 5.6 for details of the full discussions being proposed). Defence further advised the Minister that:

With respect to taxation, the tenderer has advised that reliance upon the uncertain status and timing of the proposed Division 250 of the *Income Tax Assessment Act [1997]* (Cth) would pose significant time, cost and effort to it to structure their proposal when it is unlikely to be available to apply to the project. To ensure it has certainty about the tax treatment and outcomes prior to contract signature, the tenderer would strongly prefer that the transaction triggers Division 16D of the *Income Tax Assessment Act [1936]* (Cth) as per its Alternative Tender Response 2.<sup>192</sup>

The Minister noted the current status of the clarifying discussions and tax treatment on 28 May 2006.

**4.43** The minutes of a subsequent TEB meeting held on 29 May 2006 record that during the clarifying discussions with Defence on 22 May 2006 the Prime Contractor advised that:

---

<sup>191</sup> On 21 November 2007 Defence wrote to the ANAO, following a meeting held on 31 October 2007 between the ANAO, Defence and the Project's Legal Adviser and Replacement Financial and Commercial Adviser. At the meeting the process for gaining ministerial agreement for implementing the Government's April 2006 decision was discussed. Defence's November 2007 letter confirms and expands on the meeting record of the HQJOC Project TEB Meeting No. 9, 29 May 2006, Agenda Item 7.1, pp. 2–3.

<sup>192</sup> Department of Defence, Minute, HQJOC Project/OUT/2006/195, 25 May 2006, paragraph 4, p. 1.

it would stand by the cost of its ATR2 solution as tendered, including the cost of Contingent Equity, and would seek a Private Binding Ruling on that structure from the ATO if selected as the preferred tenderer.<sup>193</sup>

**4.44** The TEB meeting minutes further record that the outcome of Defence's meeting with Treasury officials on 24 May 2006 was that: 'Treasury considered the proposal [in paragraph 4.43] was a workable solution within the intent of the Government's decision of 26 April 2006'.<sup>194</sup> As a result of the clarifying discussions and advice received from agencies and the Project's advisers, the TEB agreed that the Prime Contractor's ATR2: 'now represents the best VFM to the Commonwealth ... noting that the risks associated with [Consortium B's] STR remain as originally assessed'.<sup>195</sup>

**4.45** The TEB's conclusion in paragraph 4.44 was consistent with Defence's preferred approach, as set out at the time in Defence's *Private Financing Manual* 2002,<sup>196</sup> of using contract provisions in PPPs that triggered the application of Division 16D of the ITAA 1936. Additionally, the Project's Legal Adviser considered that proposed Division 250 would have similar tax outcomes as Division 16D. Although, the Government's decision of 26 April 2006 was to proceed with the Prime Contractor's STR—not the Prime Contractor's ATR2.

### **Settling of the Project's tax treatment**

**4.46** Following the Government's April 2006 decision on the HQJOC Projects' preferred tenderer and preferred tender response, there was a clear requirement for relevant ministers to settle: the tax model to be used by the preferred tenderer for the Project's PPP arrangement; and, the financial implications of that decision (see paragraph 4.3).

**4.47** Discussions between Defence, Treasury and Finance officials on the issue of the Project's tax treatment conducted throughout May 2006 in face-to-face meetings were not accompanied by any formal exchange of correspondence at departmental or ministerial level. Defence's records do not include any departmental file notes of discussions during this period. Defence

<sup>193</sup> HQJOC Project TEB Meeting, op. cit., Agenda Item 7.1, p. 3.

<sup>194</sup> *ibid.*

<sup>195</sup> *ibid.*, Agenda Item 13.2, pp. 6–7.

<sup>196</sup> Department of Defence, op. cit., pp. 24–27.

advised the ANAO, at a meeting on 31 October 2007, that pressure on timing before the announcement of the preferred tenderer on 30 May 2006 contributed to the lack of written records.

**4.48** The ANAO considers it important that in future Defence ensures that adequate records (fit for purpose) are maintained of advice provided to it by other agencies on key issues for projects it is administering, especially advice which Defence then acts upon, including for preparing ministerial briefings.

**4.49** In accordance with the Government's decision in April 2006, that the tax treatment be settled between the Treasurer, the Minister for Finance and Administration and the Minister for Defence, the DG HQJOC Project advised the Minister for Defence on 25 May 2006 that draft letters to update the Treasurer and the Minister for Finance and Administration on the tax treatment outcome would be provided to him during the week of 29 May 2006.

**4.50** The Minister for Defence subsequently wrote to the Minister for Finance and Administration on 22 June 2006, advising that he would be writing to him and the Treasurer in the near future about the Prime Contractor's proposed tax treatment for the Project. The Minister for Finance and Administration noted in his reply on 23 June 2006 that:

I am advised that the taxation model has been agreed by departmental officials and the cost of this model has been incorporated in the cost schedule. I note that formal endorsement of the model by the relevant Ministers will be sought in the near future.

**4.51** Defence advised the ANAO in a meeting on 30 October 2008 that a separate exchange of letters, including the Treasurer and seeking ministerial agreement to the tax treatment, did not occur. Agency records show that two of the three Ministers directed by the Government to resolve the Project's tax treatment and financial implications were aware of Defence's actions (the Ministers for Defence and Finance and Administration), but Defence did not seek the Treasurer's agreement to the tax treatment.<sup>197</sup> Defence proceeded without the formal endorsement of the Minister for Finance and Administration and the Treasurer to:

---

<sup>197</sup> The ANAO considers that Defence implemented the Government's April 2006 decision directing relevant ministers to settle the Project's financial implications when the Minister for Defence wrote to the Minister for Finance and Administration as part of meeting the requirements for approval of the Project prior to contract signature (see Chapter 5 for details).

- agree a process with the Prime Contractor to obtain a private binding ruling on a proposed tax treatment for ATR2 (see Chapter 5 for details);
- arrange for the announcement of the Prime Contractor as the preferred tenderer on 30 May 2006 (subject to reaching agreement with Defence on a number of matters during contract negotiations);<sup>198</sup>
- include the tax treatment (supported by officials in Defence, Treasury and Finance as a suitable structure for the Project's tax treatment) in cost estimates provided to the Minister for Finance and Administration when seeking a FMA Regulation 10 authorisation under the FMA Regulations 1997 for the Project;<sup>199</sup> and
- achieve commercial close with the Prime Contractor, effective from 30 June 2006, and complete the financial close on 28 July 2006 (see Chapter 5 for details).

## **Oversight of Defence's implementation of the Government's decision**

**4.52** Implementing Government decisions is a core responsibility for any government agency. To ensure the effective implementation of Cabinet decisions, the Government established the Cabinet Implementation Unit (CIU) in the Department of the Prime Minister and Cabinet in late 2003. The CIU: 'monitors the progress of the implementation of key Government decisions and reports to the Prime Minister and Cabinet on the status of these decisions', including whether decisions are being carried out on time, on budget and to Government expectations.<sup>200</sup> Defence advised the ANAO that the DG HQJOC Project was not aware of any monitoring of the Project, or direct contact with the Project Office, by the CIU.<sup>201</sup>

### *Project Governance Board*

**4.53** As illustrated in Figure 3.1 and Table 3.1, Defence created a tender evaluation organisation for the Project and specified the structure, membership

<sup>198</sup> Announced on 30 May 2006 by Senator the Hon. Sandy Macdonald, the then Parliamentary Secretary to the Minister for Defence.

<sup>199</sup> See Chapter 5 for a discussion of the Project's compliance with the Financial Management and Accountability Regulations 1997.

<sup>200</sup> Available from <[http://www.dpmc.gov.au/implementation/about\\_ciu.cfm](http://www.dpmc.gov.au/implementation/about_ciu.cfm)> [accessed 3 March 2008].

<sup>201</sup> Defence letter to the ANAO 22 October 2008.

and responsibilities of the various bodies involved in evaluating the HQJOC tender and overseeing the Project, including the Project Governance Board (PGB).<sup>202</sup> The TEP outlines four core responsibilities for the PGB including: 'to oversee the evaluation process'; and 'to monitor the health of the Project to ensure outcomes meet Commonwealth and Defence requirements'.<sup>203</sup>

**4.54** The PGB met nine times between its first meeting on 25 February 2005 and last meeting on 16 February 2006. A Finance representative attended eight of the meetings as a member, and a Treasury representative attended three of the meetings as an observer up until the end of July 2005. When the TEP, version 1, 21 February 2005, was signed the Department of the Prime Minister and Cabinet (PM&C) was included as an observer at PGB meetings. The PGB meeting on 15 March 2005 was advised that PM&C did not propose to have a representative attend the meetings.<sup>204</sup>

**4.55** It would have been expected that the PGB's oversight included monitoring Defence's implementation of the Government's April 2006 decision selecting a preferred tenderer and tender response for the Project, and subsequent negotiation and finalisation of the contract with the selected preferred tenderer. However, Defence downgraded the PGB's role as one of the bodies responsible for overseeing the Project's latter stages. The PGB's change in role occurred even though the Board noted at a meeting held on 6 July 2005 that it would have an ongoing role in the Project until the facility was fully occupied by Defence. The PGB held its last meeting in February 2006.

**4.56** The minutes of the TEB meeting held on 29 May 2006 meeting were emailed to the PGB members on the same day, with advice that the approach to the tax treatment had been resolved and the Prime Contractor's ATR2 was considered the best VFM solution (see paragraph 4.44). The email refers to the Project's Legal Process Adviser having confirmed that the process for the clarifying discussions undertaken during May 2006 (see paragraph 4.40 for participants) had been conducted appropriately, which included those participants reaching a view on the tax treatment. The Board's Chair and one

---

<sup>202</sup> In Chapter 3, Table 3.1 summarises the membership and responsibilities of the organisations represented in Figure 3.1, the HQJOC tender evaluation organisation.

<sup>203</sup> Department of Defence, *op. cit.*, p. 10.

<sup>204</sup> Version 2 of the TEP, signed on 31 May 2005, does not show PM&C as a PGB member or observer.



member's acknowledgement emails, with no substantive comment included, are on Project Office files.

**4.57** Because the PGB ceased to have an active role in the latter stages of the Project, the Board's members would not have been able to effectively monitor the cost increases to the Project as the negotiations proceeded or the reduction in the margin between the Prime Contractor's NPC of delivering the Project compared to the NPC of the risk adjusted PCB (see Chapter 5, Table 5.2).

**4.58** Although, Defence continued to advise its Minister on the Project's progress, the ANAO considered that it would have been beneficial for the PGB to have also continued its role until Defence finalised all of the contractual matters and signed the Project's contract.

## 5. Negotiation and Contract Development

---

*This chapter discusses key elements of Defence's development of a contract with the Prime Contractor for the delivery of the HQJOC facility.*

### Introduction

**5.1** The first part of the chapter discusses Defence's negotiation process with the Prime Contractor (after the Government selected the Project's preferred tenderer in April 2006) leading to signing of the Project Deed (contract)<sup>205</sup> in June 2006 and completion of the financial details for the contract in July 2006.<sup>206</sup> The final sections in the chapter describe Defence's process for obtaining the necessary financial approvals before signing the contract.

### Guidance for agencies on developing contracts

**5.2** The ANAO referred primarily to the following sources of guidance on contract management when reviewing Defence's negotiation and contract development process for the HQJOC Project:

- DPPM (Version 5, June 2004);
- various publications from the Financial Management Guidance series produced by Finance; and
- the ANAO's *Better Practice Guide—Developing and Managing Contracts*, February 2007.

**5.3** The publications referred to in paragraph 5.2, and other relevant material of a general nature, are readily available to agencies either in Internet-based or printed format. For large or complex tenders, agencies would be expected to assess the need for additional, external expert advice (see Chapter 2, for a list of the Project's external advisers).

---

<sup>205</sup> The HQJOC Project Deed defines the provision of, and payment for, services over the project period. The term 'Project Deed' is used in this report to refer to the formal contract agreement between the Commonwealth and the Prime Contractor and includes a number of other associated deeds entered into by these parties.

<sup>206</sup> Under a PPP, the financiers wait until after the commercial aspects have been agreed at contract signature—signing of the Project Deed represented the commercial close for the HQJOC Project—before finalising the financial aspects of the transaction. The latter date is called the financial close.

## Risk management and contract development

5.4 Managing risk is fundamental to effective public administration and, therefore, essential to all aspects of government procurement processes, including the development of contracts.<sup>207</sup> A risk management process involves identifying and rating the severity of any potential risks, identifying mitigation measures, applying risk treatments as required, and periodically monitoring the original risk assessment and acting upon any changes.

5.5 For the Project's tender process, Defence's approach to risk management for PPPs was described in the *Private Financing Manual* (2002).<sup>208</sup> The Project's final Risk Allocation Matrix (August 2006), prepared by the Project's Legal Adviser, does not identify any risks associated with Defence effectively performing key administrative functions as part of developing the contract with the Prime Contractor. However, an internal working document from the Project Office has the following proposed treatments for identified risks, to be actioned by the DG HQJOC Project, that are relevant to developing the contract:

- ensure that necessary Commonwealth approvals are able to be obtained in a timely manner consistent with the tender evaluation program; and
- prepare a strategy for negotiating outstanding issues and forming a contract.<sup>209</sup>

## Negotiation with the Prime Contractor

### Clarifying discussions with the Prime Contractor

5.6 As indicated in paragraph 4.40, after the Government's decision on 26 April 2006 to select the Prime Contractor as the preferred tenderer, Defence sought the Minister for Defence's agreement to hold clarifying discussions

<sup>207</sup> ANAO *Better Practice Guide—Developing and Managing Contracts*, February 2007, p. 5.

<sup>208</sup> Defence later produced the *Private Financing - Guidelines* (2007), maintained by the department's Chief Finance Officer Group. The 2007 guidelines include specific advice on: 'Risk Management' and a 'Risk Identification and Assessment Workshop Guidance Note'.

<sup>209</sup> Defence, Headquarters Joint Operations Command Project, *Project Risk Register* (Version 11), 5 July 2006, p. 2.

with the Prime Contractor on a range of issues during the remaining period of competitive tension before the preferred tenderer was publicly announced.<sup>210</sup>

5.7 The Minister agreed on 12 May 2006 and the DG HQJOC Project wrote to the Prime Contractor on the same day advising:

The [Request for Final Revised Offer (RFRO)] evaluation has identified a number of divergences in [the Prime Contractor's] response to the RFRO which the Commonwealth considers constitutes material deficiencies and, in accordance with paragraph 6(a) of the RFRO, Defence would like to enter into clarifying discussions with [the Prime Contractor].

The discussions were to remain confidential and were not to be seen as constituting any legally binding rights in favour of the Prime Contractor or as an intention by Defence to enter into arrangements or contracts with the Prime Contractor.

5.8 The key issues to be addressed during the discussions between Defence and the Prime Contractor were grouped under five headings that aligned with the TEWGs' evaluation criteria: commercial; financial; design and construction; facilities management; and corporate capability (see Chapter 3 for details of the evaluation methodology). The Prime Contractor agreed on 13 May 2006 to Defence's request and these initial discussions went on to the end of May 2006 (see paragraph 4.40 for details).

## **Outcomes from the clarifying discussions**

### *Contingent equity guarantee*

5.9 The Prime Contractor's ATR2 response to the RFRO in January 2006 was not fully costed at the time Defence evaluated the tenderers' RFRO responses. This was because this tender response involved a funding model incorporating a contingent equity guarantee and the Prime Contractor had not approached the market for pricing of this component before submitting its ATR2 to the RFRO. The Commercial TEWG's RFRO final report notes that, as a consequence, the Prime Contractor's ATR2 used an indicative price of \$5 million for a contingent equity guarantee. In this circumstance, the Prime Contractor's ATR2 remained not fully costed in April 2006 when the

---

<sup>210</sup> The discussions included the proposed taxation treatment detailed in Chapter 4.

Government considered the RFRO tender responses and selected the preferred tenderer.

**5.10** In May 2006, Defence discussed with the Prime Contractor the matter of ATR2 (which was predicated on triggering the operation of Division 16D of the ITAA 1936) requiring the provision by a third party of a contingent equity guarantee to avoid the operation of section 51AD of the ITAA 1936 (see Chapter 4 for a detailed discussion of the Project's tax treatment). The Prime Contractor confirmed in a letter to Defence dated 29 May 2006 that ABN AMRO Australia Limited and Leighton Contractors Pty Limited (consortium members) would each provide 50 per cent of the contingent equity guarantee described in ATR2. In a separate letter to Defence, also dated 29 May 2006, the Prime Contractor confirmed that it would offer ATR2 on the same financial bases proposed in its RFRO response in January 2006 on a fully underwritten basis. The ANAO observed that a \$5 million contingent equity guarantee had been included in the Prime Contractor's ATR2 financial model submitted at RFRO in January 2006, which was also included in the financial close model on 28 July 2006.

*Tender Evaluation Working Group conclusions in May 2006*

**5.11** When the 29 May 2006 TEB meeting was held, the Prime Contractor had clarified its position on the key issues raised by Defence and the leaders of four TEWGs found that: 'the original TEWG's assessment stands' and, therefore, the Prime Contractor as the preferred tenderer still represented the best VFM for the Commonwealth.<sup>211</sup> A small number of matters were unresolved and the TEWGs involved recommended that Defence pursue the remaining matters during negotiations with the preferred tenderer. Defence advised its Minister on 29 May 2006 that:

the tenderer has conceded or moved somewhat towards the Commonwealth's position on a number of the matters, thereby improving the risk profile in the Commonwealth's favour, and has retained its position on other matters. These matters will be taken up in negotiations.

---

<sup>211</sup> There is no similar comment in the meeting minutes for the Financial TEWG. HQJOC Project TEB Meeting, op. cit., Agenda Item 9, pp. 3–5.

**5.12** The key financial issue under discussion was the impact of a change to the target availability date.<sup>212</sup> Before the site could become fully operational, Defence would still need to install the C4I systems.

#### Financial impact of changing the facility's target availability date

**5.13** In a letter to the Prime Contractor dated 22 May 2006, Defence raised concerns with a potential change to the target availability date from 9 July 2008 to 9 October 2008 and asked the Prime Contractor to indicate:

- (a) what changes would be made to the tendered price if the Target Availability Date remained at 9 July 2008; and
- (b) what change would be made to the amount in (a) if the preferred tenderer were announced on or before 31 May 2006.

**5.14** The Prime Contractor's response to Defence on 29 May 2006 advised that the original target availability date of 9 July 2008 could be achieved if the preferred tenderer was announced on or before 31 May 2006. However, due to the compression of time for some activities, the design and construction (D&C) price would increase by \$3.6 million and the annual service payment for 2009–10 would increase for the Prime Contractor's ATR2 option from \$36 922 855 to \$37 124 152, an increase of \$201 297. The Prime Contractor's advice assumed that commercial close would occur on 23 June 2006 and financial close on 28 July 2006. The Prime Contractor also provided a second option, based on a later announcement of the preferred tenderer with the same target availability date, which further increased the D&C cost and the annual service payment.

**5.15** The TEB was presented with the financial information in Table 5.1 to consider at its meeting on 29 May 2006.

---

<sup>212</sup> A change in the target availability date would impact on the target full service commencement date, which is Defence's full occupation of the HQJOC facility.

**Table 5.1**

**The Prime Contractor's revised costing for ATR2—assuming the preferred tenderer was announced by 31 May 2006**

2006–07 Budget prices outturned	Risk Adjusted Project Cost Benchmark (\$m)	ATR2 (RFRO) (\$m)	ATR2 (post-clarification) (\$m)
Net Present Cost (NPC) at 5.35 per cent discount rate	508.1	503.9	506.5
Insurance		13.3	13.3
Taxation		18.7	18.7
Gross NPC		535.8	538.5
Annual service payment		37.4	37.6
Capital component		25.0	25.2
Operating component		12.4	12.4

Source: HQJOC Project Tender Evaluation Board Meeting No. 9, 29 May 2006, Agenda Item 9.1, p. 5.

### *Project Cost Benchmark*

**5.16** Table 5.1 reflects Defence's advice to the ANAO that, in accordance with the Project's TEP, the DG HQJOC Project approved the adjustment of the risk adjusted PCB from \$496.2 million to \$508.1 million on 26 April 2006 to reflect interest rate movements and an increase in the estimated utility costs for electricity, which had previously been understated.<sup>213</sup>

**5.17** In Chapter 3, Table 3.6 presents the Financial TEWG's NPC calculations in February 2006 for the Prime Contractor's RFRO tender responses. At RFRO, the Prime Contractor's ATR2 NPC (\$492.1 million) was \$4.1 million less than the NPC of the risk adjusted PCB (\$496.2 million). Table 5.1 shows that in May 2006 the margin between the Prime Contractor's ATR2 NPC and the risk adjusted PCB had decreased to \$1.6 million after Defence requested that the Prime Contractor recalculate the cost of the tender due to a change by Defence to the announcement date of the preferred tenderer. However, the NPC of ATR2 still remained under that of the risk adjusted PCB. The Department of Finance and Administration's member of the TEB advised members at the May meeting that, as there had been no change to the overall risk profile for the

<sup>213</sup> Defence letter to the ANAO dated 22 October 2008.

Project following clarifying discussions with the Prime Contractor, no further adjustment of the PCB was required at that point.

*Advice to the Minister on value for money*

5.18 Defence advised its Minister on 29 May 2006 of the impact of delaying the target availability date for the HQJOC facility. The Minister was provided with the same advice and figures reported to the TEB as being those required to achieve the original target availability date of 9 July 2008. Defence advised that:

The HQJOC Project Tender Evaluation Board met on 29 May 2006 and agreed that the tenderer's Alternative Tender Response 2 solution, inclusive of the \$3.6 million increase in cost, represented the best value for money solution to the Commonwealth.

5.19 The Minister noted Defence's advice and agreed to announce the preferred tenderer on or before 31 May 2006 so that contract negotiations could start.<sup>214</sup> A delay in finalising the planned public announcement at that stage of the tender process would have impacted on Defence's ability to achieve a satisfactory full service commencement date for the new facility and increased the preferred tenderer's bid and therefore the Project's cost.

5.20 As discussed in Chapter 4, Defence did not negotiate further with Consortium B after the Government's selection of a preferred tenderer on 26 April 2006. However, Defence retained the ability to negotiate with Consortium B if discussions with the Prime Contractor were unsatisfactory.

**Contract negotiation—after the Prime Contractor announced as the preferred tenderer**

5.21 International experience demonstrates that the tender processes related to PPPs are often complex and generally need a significant period of time to finalise contract details after a preferred tenderer is selected.<sup>215</sup> This leaves the preferred tenderer in a situation without competition where many costs are still uncertain. Project complexity often means the cost of the winning tender

---

<sup>214</sup> The Parliamentary Secretary to the Minister for Defence announced that the Prime Contractor was the preferred tenderer on 30 May 2006, the day before the Minister signed his agreement on the departmental Minute. Defence documents dated 29 May 2006 indicate that the HQJOC Project Office was in verbal contact with the Minister's Office on that day and had verbal agreement to the recommendations in the Minute dated 29 May 2006.

<sup>215</sup> Barton, op. cit., p. 10.



will increase during the negotiations, although this may be attributable to governments changing specifications. A Canadian study argues that these cost increases and time delays are not factored into final on time and on budget calculations.<sup>216</sup>

**5.22** The United Kingdom's National Audit Office (NAO) cites the need for good negotiations with the preferred tenderer, arguing that: 'it is hard to avoid some weakening of competitive tension ... experience shows that there is a high risk of the terms of the deal changing so that they are less favourable to the department'.<sup>217</sup> As an example, preferred tenderer negotiations conducted by the Ministry of Defence to build the Joint Services Command and Staff College in the United Kingdom took 16 months, with the price increasing by four per cent between the selection of the preferred tenderer and the finalisation of the contract. The NAO observed that: 'Such lengthy negotiations with the preferred bidder were, however, a common problem on other Private Financing Initiative projects at that time'.<sup>218</sup> The NAO further noted that standardised guidelines had subsequently been issued to agencies that should reduce the time taken to negotiate future PPPs.

**5.23** The Minister for Defence's media release announcing the Prime Contractor as preferred tenderer for the Project noted that:

The selection of the [the Prime Contractor] as the preferred tenderer is conditional on the consortium reaching agreement with Defence on a number of matters during contract negotiations. This is not unusual for a project of the scope and scale of the Headquarters project.<sup>219</sup>

**5.24** The Project's *Process Plan* anticipates that the final phase of the Project would be contract negotiation and finalisation and notes that:

negotiations and other dealings with the preferred tenderer(s) should be conducted fairly and equitably whilst maintaining competitive tension for the

---

<sup>216</sup> Stuart Murray, *Value for Money? Cautionary Lessons about P3s from British Columbia*, Canadian Centre for Policy Alternatives, Vancouver, 2006, p. 20.

<sup>217</sup> National Audit Office, *Examining the value for money of deals under the Private Finance Initiative*, Report HC 739 Session 1998–99, NAO, 1999, p. 16.

<sup>218</sup> National Audit Office, *The Joint Services Command and Staff College*, Report HC 537 Session 2001–02, NAO, 2002, p. 3.

<sup>219</sup> Department of Defence, Media Release MIN89/06, 30 May 2006, *New \$300 million Headquarters Joint Operations Command* [Internet]. Defence, Canberra, 2006, available from <<http://www.defence.gov.au>> [accessed 11 February 2008].

benefit of the Commonwealth and not undermining the bases upon which the preferred tenderer(s) was selected.<sup>220</sup>

The DG HQJOC Project was to conduct the negotiations, with assistance from other Defence personnel and advisers as required. The *Process Plan* did not specify a role for the PGB during this phase nor put in place alternative oversight arrangements, other than a requirement for the Legal Process Adviser to review and advise on the negotiations.

**5.25** Defence wrote to the Prime Contractor on 30 May 2006 confirming its appointment as the preferred tenderer on the basis of its ATR2 and a target availability date of 9 July 2008. Negotiation of the Project's deed documents was to start in early June with a view to reaching commercial close by 23 June 2006.

**5.26** The DPPM advises Defence officials that: 'for higher value Complex and Strategic procurements there should be a negotiation plan (often called a contract negotiation directive) in place before entering into negotiations'.<sup>221</sup> The manual reminds staff of the importance of sound record keeping that establishes a clear audit trail for accountability purposes and one that can be relied upon in the event of future legal disputes. On 2 June 2006, the then Head of Infrastructure Division, Corporate Services and Infrastructure Group, under which the Project resided, issued the DG HQJOC Project with a detailed Negotiation Directive.

**5.27** Most of the documents that were the subject of the negotiations between Defence and the Prime Contractor in June 2006 had previously been issued as part of the RFRO in October 2005. Also in accordance with the DPPM, the Legal Adviser provided Defence with negotiation reports in June 2006 recording the outcome of discussions with the Prime Contractor and its advisers on a range of matters of difference within the negotiation documents.

## **Outcome of the negotiations—commercial close**

**5.28** In contrast with general international experience with PPPs, Defence conducted negotiations and reached commercial close with the Prime

---

<sup>220</sup> Australian Government Solicitor, op. cit., p. 2.

<sup>221</sup> Department of Defence, op. cit., paragraph 710, p. 5.7.2.

Contractor one month after the announcement of the Prime Contractor as preferred tenderer, which is a relatively short time for a complex project.

**5.29** The DPPM advises officials that: ‘For Complex and Strategic purchases the original offer is likely to significantly differ from the final offer or negotiated outcome’, and this was the case for the Project.<sup>222</sup> The DG HQJOC Project’s report on negotiations from 5 June 2006–22 June 2006 states that:

- The risk allocation had been satisfactorily concluded within the Commonwealth’s position or fall-back position.
- The Legal Adviser had confirmed that the Project’s documents reflected instructions given to it by Defence during contract negotiations and, where applicable, reflected current market practice in PPP projects.
- The Prime Contractor sought to include additional items, amounting to approximately \$6.45 million, in the cost of the base project.<sup>223</sup>

**5.30** Table 5.2 shows a comparison of the PCB to the Prime Contractor’s ATR2 cost from the close of the RFRO in January 2006 to the end of the negotiation phase in June 2006.

**Table 5.2**

**HQJOC Project Cost Benchmark comparison with the Prime Contractor’s Alternative Tender Response 2**

Date	Project Cost Benchmark <sup>A</sup> (\$m, 2006–07 Budget prices, outturned)	Prime Contractor’s ATR2 (\$m, 2006–07 Budget prices, outturned)	Margin (\$m)
<b>19 January 2006:</b> Tender Request for Final Revised Offer	496.2	492.1	4.1
<b>21 April 2006:</b> Defence’s submission to the Government	508.1	503.9	4.2

<sup>222</sup> *ibid.*, paragraph 726, p. 5.7.5.

<sup>223</sup> The total includes \$3.6 million in acceleration costs previously advised by the Prime Contractor in May 2006 during the clarification discussions. The additional amount was required to meet a target availability date of 9 July 2008 due to a delay in Defence announcing the preferred tenderer (see paragraph 5.14).

Date	Project Cost Benchmark <sup>A</sup> (\$m, 2006–07 Budget prices, outturned)	Prime Contractor's ATR2 (\$m, 2006–07 Budget prices, outturned)	Margin (\$m)
<b>29 May 2006:</b> Clarifying discussions end with the Prime Contractor	508.1	506.5	1.6
<b>23 June 2006:</b> End of negotiation phase with the Prime Contractor	515.64	514.7	0.94

Note: (A) NPC at 5.35 per cent discount rate.

Source: ANAO analysis.

**5.31** Table 5.2 shows the margin between the NPC of the Prime Contractor's final tendered price and the PCB to be \$0.94 million at the end of the negotiation phase and immediately preceding signing of the Project Deed.<sup>224</sup> The DG HQJOC Project's Negotiation Report notes, in relation to the changes to the PCB and ATR2 illustrated in Table 5.2, that: 'the outcome of negotiations is that [the Prime Contractor's] ATR2 still remains value for money to the Commonwealth, albeit on a slim margin'.<sup>225</sup>

**5.32** The annual service payments also increased in June 2006. The Negotiation Report advises that the estimated payment for 2009–10, after negotiation with the Prime Contractor, was less than the maximum amount authorised in the Negotiation Directive. However, when the impact of interest rate movements between RFRO (19 January 2006) to the end of the negotiation period (22 June 2006) was included the amount exceeded the Negotiation

<sup>224</sup> The ANAO noted that the Negotiation Report (22 June 2006) cited the PCB as being \$515.5 million at the end of negotiations with the Prime Contractor, which differs from later advice in a range of Defence's documents that the PCB was \$515.64 (23 June 2006). Defence was unable to explain the small difference (\$0.14 million) between the two PCB figures, however, Defence documents dated after 22 June 2006 consistently refer to the final NPC of the PCB being \$515.64. The ANAO agreed with Defence that this report would cite the final PCB as being \$515.64. The ANAO suggested that sound practice would be to document any updates to the PCB, at the level of adjustments to individual components and the effect on the estimated total NPC. The ANAO considered that a file note, or similar, signed by the DG HQJOC Project, who was responsible for authorising any updates to the PCB, would have been sufficient to satisfy record keeping requirements.

<sup>225</sup> Department of Defence, *HQJOC Project – Report on Negotiations*, 22 June 2006, p. 2.

Directive.<sup>226</sup> The Report notes that another interest rate rise was possible between commercial close (30 June 2006) and financial close (28 July 2006), when the Commonwealth's exposure to interest rate rises would end. (See Table 6.1 in Chapter 6 for a comparison of the changes during the period from January 2006–June 2006 to the estimated annual service payments).

**5.33** The Negotiation Report advised that, in order to absorb the cost of interest rate rises and remain within the maximum amount authorised in the Negotiation Directive, Defence would need to reduce the scope of the Project. This is followed by the conclusion that, if this was done:

In all likelihood, [the Prime Contractor] would be unwilling to proceed with the project, given the history and present stage of the procurement process. Delivering the project under direct procurement is not feasible given a number of high risks, including the time and cost to deliver, impact and reaction from industry, and political risk.<sup>227</sup>

Defence had previously advised the Government in April 2006 that a decision to use direct procurement for the Project, instead of a PPP, would have resulted in a delay of up to 12 months.

**5.34** The DG HQJOC Project recommended on 22 June 2006 to the Head of Infrastructure Division (see paragraph 5.26) that Defence provide the funds required to meet the impact of increased interest rates on the annual service payments, thus enabling the Project documents to be signed with the Prime Contractor on 23 June 2006. (For a detailed discussion of the annual service payments see Chapter 6.)

### *Contract signature*

**5.35** Defence and the Prime Contractor signed most of the Project's contractual documents on 23 June 2006 and achieved commercial close on 30 June 2006.<sup>228</sup> The Minister announced on 5 July 2006 that Defence had signed a contract with the Prime Contractor, the preferred tenderer for the

---

<sup>226</sup> The Commonwealth bore the risk of interest rate rises from the close of the tender on 19 January 2006 until financial close on 28 July 2006. After financial close, the Prime Contractor bears the risk for the remainder of the 30 year term.

<sup>227</sup> Department of Defence, op. cit., p. 3.

<sup>228</sup> When the Project Deed was signed on 23 June 2006 one contract document remained unsigned. All of the contract documents were held in escrow until the remaining contract document was signed. The date of the Project Deed is the date on which that final document was signed—30 June 2006.

Project, and the value of the contract would become available after the Prime Contractor achieved financial close with Defence on 28 July 2006.<sup>229</sup>

## Financial close

5.36 The Defence *Private Financing Manual* advises that:

Once agreement is reached between Defence and the bidder on the terms and conditions of the contract [commercial close], the bidder will generally have to secure final arrangements with their financiers. ... Financial close occurs after the financier completes due diligence assessments and agrees on their terms with the contractor.<sup>230</sup>

5.37 The Minister announced on 18 August 2006 that financial close had been achieved with the Prime Contractor (on 28 July 2006) and after the HQJOC facility was fully operational in late 2008 Defence would pay the Prime Contractor an annual service payment for the remaining 28 years of the 30 year contract—with a first full-year payment of \$39.99 million in 2009–10.<sup>231</sup>

5.38 See Chapter 6 for details of the financial close figures and the Project's annual service payment schedule.

### *Conditions precedent in the Project Deed*

5.39 Defence advised the Minister on 9 August 2006 that:

[The Prime Contractor] and its financiers executed all the required financial documents and all but two of the Condition Precedent requirements by 28 July 2006 [financial close]. The two Condition Precedent matters were agreed by me [the DG HQJOC Project], on advice from the HQJOC Project legal advisers, to be treated as Condition Subsequent matters.<sup>232</sup>

The following sections discuss the two Conditions Precedent referred to in Defence's August 2006 advice to the Minister.

---

<sup>229</sup> Department of Defence, Media Release 103/2006, 'Contract Signature for HQJOC Project' [Internet]. Minister for Defence, Canberra, 5 July 2006, available from <<http://www.defence.gov.au>> [accessed 6 June 2007].

<sup>230</sup> Department of Defence, op. cit., p. 9.

<sup>231</sup> Department of Defence, Media Release 123/2006, 'Financial Closure Achieved for \$300 million HQJOC Project' [Internet]. Minister for Defence, Canberra, 18 August 2006, available from <<http://www.defence.gov.au>> [accessed 5 July 2007].

<sup>232</sup> A Condition Subsequent in contract law brings a duty to an end, whereas a condition precedent initiates a duty. See footnote 184 for a definition of condition precedent.

### Private binding ruling on taxation treatment

**5.40** Defence advised tenderers in the RFRO documentation that a Condition Precedent in the Project Deed would require a private binding ruling from the ATO for the final tax arrangement for the Project.

**5.41** In the Project Deed, Schedule 1, Conditions Precedent, clause 3.1, paragraph (j) requires that the Prime Contractor provide:

A private binding tax ruling from the Australian Tax Office with respect to the non-application of section 51AD of the *Income Tax Assessment Act 1936* to the proposed structure and the proposed arrangements the subject of the Project Documents.<sup>233</sup>

Defence had determined that the Condition Precedent was to be satisfied by the target financial close date of 28 July 2006.

**5.42** When the Prime Contractor lodged an application for a private ruling with the ATO on 16 June 2006, it expected that a ruling would be available by the target financial close date of 28 July 2006. The private ruling was in fact finalised by the ATO on 1 September 2006 and: ‘confirmed that section 51AD of the ITAA 1936 has no application to the Prime Contractor in respect of the project’ for the period from 30 June 2006–30 June 2036 inclusive, being the full 30 year term of the Project.<sup>234</sup>

**5.43** Included in the Project Deed (Part B – Preliminary Matters, Conditions Precedent, clause 3.1(e)), was the capacity for Defence to waive the requirement for a specified period of time if the Prime Contractor met certain conditions including acting in accordance with clause 3.1(e)(ii): ‘the Contractor has been and is diligently pursuing the satisfaction of that Condition Precent’. Defence agreed to waive the private binding tax ruling Condition Precedent until a final date of 29 September 2006.

**5.44** Defence advised the Minister on 11 September 2006 that the Prime Contractor had satisfied the private binding tax ruling Condition Subsequent.

---

<sup>233</sup> Because Division 16D does not apply where section 51AD applies, Defence required the ruling in order to implement the Prime Contractor’s ATR2 tender option.

<sup>234</sup> ATO, Notice of private ruling, Authorisation Number 66433, dated 1 September 2006, applying to the Prime Contractor and the HQJOC Project.

## Stamp duty for Operation contract

**5.45** The Project Deed (Schedule 1, Conditions Precedent, clause 3.1, paragraph (g)) requires that the Prime Contractor ensure that:

The Commonwealth has received evidence that any stamp duty payable in connection with the entry into the Project Documents (other than those to be executed after Financial Close) has been paid.

Defence advised the Prime Contractor, in a letter dated 28 July 2006, that paragraph(g) had been satisfied except in relation to the Operation contract, for which the Condition Precedent was waived conditional upon the Prime Contractor providing an original stamped copy of the Operation contract to the Commonwealth after financial close was achieved.

**5.46** Defence advised the Minister on 9 August 2006 that the Operation contract: 'has been executed but may take up to 60 days to be processed by the NSW Office of State Revenue. This delay will have no impact on the project.'

**5.47** Defence also advised the Minister in September 2006 that the Prime Contractor had forwarded a stamped copy of the Operation contract and satisfied the Condition Subsequent, which meant that all of the matters outstanding at financial close had been finalised.

### *Treatment of catering services*

**5.48** According to the tender documentation, the Prime Contractor is required to provide catering services for the HQJOC facility. Defence had intended to include the catering service rates in the commercial close documentation, but due to an oversight by Defence, this was not completed at that time. Defence became aware of the oversight prior to financial close, but chose to finalise the matter separately with the Prime Contractor at a later date.

**5.49** Defence advised the ANAO in October 2008 that: 'processes [including for catering services] are being agreed in the Operation Plans Development process, which is set for conclusion prior to the start of full operational service [November 2008]'.<sup>235</sup> Defence subsequently advised the ANAO, as part of the agency's response to the proposed audit report, that: 'The details on 'how' the

---

<sup>235</sup> Defence letter to the ANAO dated 22 October 2008.



catering services were provided [are] in the Facilities Management Plan that was submitted by the Prime Contractor to Defence in October 2008'.<sup>236</sup>

**5.50** Payments for Defence's use of catering services at the HQJOC facility are to be included as a separate item in the Prime Contractor's monthly invoice for the annual service payment component (see Chapter 6 for details of the annual service payments).

## Financial approvals

### Current financial framework

**5.51** Entering into a legally binding agreement for the Project with the Prime Contractor relied on Defence's administration of significant financial framework functions. Chapter 2 outlines the legislative and procurement framework for PPPs—Defence is required to comply with the former and take into account policy and guidelines for the latter, as one of 104 Australian Government agencies that the FMA Act applies to.<sup>237</sup> The Financial Management and Accountability Regulations 1997 (FMA Regulations), created under section 65 of the FMA Act, prescribe matters necessary or convenient for carrying out or giving effect to the Act and cover the approval of spending proposals and entering into contracts.<sup>238</sup>

### Application of the FMA Regulations

**5.52** The ANAO examined Defence's compliance, for the Project, with the following FMA Regulations relating to commitments to spend public money, in accordance with section 44 of the FMA Act:

- Regulation 9 Approval of spending proposals—principles;
- Regulation 10 Approval of future spending proposals;
- Regulation 11 Approval of spending proposals—officials;
- Regulation 12 Approval to be recorded; and

<sup>236</sup> Defence letter to the ANAO dated 9 April 2009.

<sup>237</sup> The number of FMA Act agencies current as at 6 November 2008. A list of FMA Act agencies is available from the Department of Finance and Deregulation website at <<http://www.finance.gov.au>> [accessed 13 November 2008].

<sup>238</sup> *ibid.*

- Regulation 13 Entering into contracts etc.

Defence also used Regulation 26, Chief Executive may delegate powers, under section 53 of the FMA Act, to create an instrument of delegation to enable the DG HQJOC Project to sign the Project Deed and related documents instead of the Secretary of Defence (see Table 5.3).

**Table 5.3****Defence's compliance with the FMA Regulations relating to commitments to spend public money for the HQJOC Project**

FMA Regulation	Compliant	Date
<b>Regulation 9 Approval of spending proposals—principles</b> Requires that an approver of a proposal to spend public money must be satisfied that the proposed expenditure is in accordance with the policies of the Commonwealth, will make efficient and effective use of the money and, if the proposal is one to spend special public money, is consistent with the terms under which the money is held.	✓	23 June 2006
<b>Regulation 10 Approval of future spending proposals</b> Requires written authorisation from the Finance Minister (or the Finance Minister's delegate) before approving a proposal to spend public money, where expenditure under the proposal is not supported by sufficient available appropriation.	✓	23 June 2006
<b>Regulation 11 Approval of spending proposals—officials</b> Requires that an official must not approve a proposal to spend public money unless authorised by a Minister or Chief Executive, or by or under an Act, to approve the proposal.	✓	23 June 2006
<b>Regulation 12 Approval to be recorded</b> Requires that, where approval of a spending proposal is not given in writing, the approver must record the terms of the approval in a document as soon as practicable after the approval is given.	NA <sup>A</sup>	NA <sup>A</sup>
<b>Regulation 13 Entering into contracts etc</b> Requires that a person must not enter into a contract, agreement or arrangement under which public money is, or may become, payable unless a spending proposal for the proposed contract, agreement or arrangement has been approved under Regulation 9 and, if necessary, in accordance with Regulation 10.	✓	23 June 2006
<b>Regulation 26 Chief Executive may delegate powers</b> The Chief Executive of an agency may delegate to an official, by signed instrument, any of the Chief Executive's powers or functions under the FMA Regulations.	✓	19 June 2006

Note: (A) NA (not applicable) as approvals were given in writing prior to contract signature.

Source: ANAO analysis.

**5.53** Table 5.3 shows that the required FMA Regulation 9 and FMA Regulation 10 approvals were both given on 23 June 2006—the same day the Project Deed was signed with the Prime Contractor. Emails from Defence

clearly indicate that the Project Office was waiting for confirmation of compliance with the FMA Regulations before signing the contract. Defence advised the Minister on 28 June 2006, that:

The HQJOC Project Contract between Defence and [the Prime Contractor] was signed late in the evening of 23 June 2006 following advice that the Minister for Finance and Administration had exercised his powers under Regulation 10 of the *Financial Management and Administration Act 1997* to authorise officials to consider approving the expenditure for this project.

### **FMA Regulation 9 and 10 approvals**

**5.54** In order to sign the HQJOC Project Deed with the Prime Contractor in June 2006, Defence acted in accordance with the FMA Act and complied with the necessary FMA Regulations relating to commitments to spend public money. The ANAO noted that the departmental advice to the Defence delegate, dated 23 June 2006, recommending FMA Regulation 9 approval be given for the Project did not contain a total cost for the Project or an estimated annual service payment schedule. However, the Minister for Finance's FMA Regulation 10 approval dated 23 June 2006 contained the detailed expenditure for the Project in the form of estimates for the 30 year annual service payment schedule.

**5.55** Defence later advised the Minister for Defence on 20 August 2006 that the annual service payments 2008–09 to 2035–36, agreed at financial close with the Prime Contractor, exceeded Defence's FMA Regulation 10 authorisation. However, Finance advised Defence that as the increased costs were attributable to interest rate movements between the time of the approval (June 2006) and financial close (July 2006)—and were foreshadowed in the Finance Minister's FMA Regulation 10 approval—a further authorisation was not required.<sup>239</sup>

---

<sup>239</sup> Email from Finance to Defence dated 18 August 2006.

## 6. Payment Schedule

---

*This chapter explains and assesses the operation of the annual service payment schedule for the HQJOC facility.*

### Introduction

**6.1** A central element of reaching financial close with the Prime Contractor for the Project in July 2006 was finalising the annual service payments for the future operation and maintenance of the facility from 2008–09 to 2035–06.

**6.2** The ANAO evaluated Defence's management of the process for establishing a future annual service payment schedule for the Project with the Prime Contractor, and the potential impact of the schedule in terms of Defence achieving VFM by delivering the Project as a PPP.

### Annual service payments

#### Background

**6.3** Defence documents show that in 2003–04 the Government approved a Budget allocation of \$301 million for Defence for the estimated capital cost of the Project. In 2006–07, the revised estimated capital cost was \$339.2 million (Budget prices, outturned) comprising:

\$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, outturned) per annum commencing in 2008–09 as a contribution to the Annual Service Payment to [the Prime Contractor]. The remaining funds required to meet the Annual Service Payments are programmed in Defence's Financial Estimates and future budget allocations.<sup>240</sup>

---

<sup>240</sup> Letter from the Minister for Defence to the Chair, Senate Standing Committee on Foreign Affairs, Defence and Trade, dated 1 November 2006.

## Payment schedule

**6.4** As previously discussed, Defence has signed a 30 year lease agreement with the Prime Contractor to deliver the HQJOC facility and services. In total at financial close on 28 July 2006—including annual service payments to the Prime Contractor—the financial modelling determined that the Project's Net Present Value (NPV) would be \$572.2 million (in 2006–07 Budget prices outturned).<sup>241</sup> Defence advised the Minister in August 2006 that the Prime Contractor's final 'NPC' for the Project was \$572.2 million (see paragraphs 6.18–6.20).

### *Use of Net Present Cost (Project Cost Benchmark) and Net Present Value*

**6.5** The ANAO found that Defence's documents referred to both the Project's 'NPV' and 'NPC'. Defence clarified for the ANAO that NPC was correct when referring to comparisons of the tenderers' responses to the PCB.<sup>242</sup> As noted at Table 3.6 in Chapter 3, Defence removed the NPC of insurance and tax from the tenderers' responses for tender evaluation purposes. Insurance costs were not included in the PCB and the NPC of tax was also removed from the PCB on the basis that it was considered to be a net benefit to the Commonwealth that offsets the costs of the Project. The PCB is only used as an evaluation tool until commercial close—contract signature—is achieved.<sup>243</sup> At financial close, the financial modelling for the Project determined the whole of life NPV, which included tax, insurance and interest rate changes after the commercial close. The NPC at commercial close is not directly comparable to the NPV at financial close, given the differing basis for the calculations, however, the Project's final NPV of \$572.2 million is 11 per cent higher than the estimated NPC of the Prime Contractor's ATR2 of \$514.7 million at commercial close.

---

<sup>241</sup> Net Present Value (NPV) is the future cash flows, discounted for timing and risk, less the cost of investing in the project calculated in terms of today's worth. As discussed in Chapter 1, the NPV figure does not include the cost of the separate command, control, communications, computing and intelligence (C4I) systems contract. (The value of the C4I contract was estimated by Defence to be up to \$58.5 million (in 2006–07 Budget prices)). In nominal terms (price of the day), the Project's \$572.2 million NPV is approximately \$1 200 million (exclusive of GST).

<sup>242</sup> Meeting between the ANAO and Defence on 3 November 2008.

<sup>243</sup> As discussed in Chapter 5, the Commonwealth bore the risk of interest rate rises from the close of the tender on 19 January 2006 until financial close on 28 July 2006. After financial close, the Prime Contractor bears the risk for the remainder of the 30 year term.

**6.6** Defence's lease with the Prime Contractor for the facility started on 30 June 2006 and is scheduled to terminate on 30 June 2036. Under the agreement, Defence does not make any lease payments until after the construction of the facility, which Defence announced as completed on 11 July 2008. The C4I systems were installed, tested and commissioned after that date. Defence announced the completion of the C4I work on 14 November 2008 and that the new facility was ready for use by its intended Defence occupants.<sup>244</sup>

**6.7** Defence and the Prime Contractor agreed a base case financial model, including an estimated annual service payment schedule from 2008–09 to 2035–36, at financial close.<sup>245</sup> The annual service payment is paid as a monthly service payment in arrears. If required, the Project Deed enables Defence to adjust the monthly payments for abatements for poor performance of service during the previous month.<sup>246</sup>

**6.8** The first annual service payment is a part year payment in 2008–09, which takes into account that only a small number of the Prime Contractor's staff would be required to support the C4I process from July to November 2008.<sup>247</sup> The first full year payment starts in 2009–10, as illustrated in Figure 6.1.

---

<sup>244</sup> Parliamentary Secretary for Defence Support, the Hon. Dr Mike Kelly MP, Media Release *Headquarters Joint Operations Command Project – Facilities Handover* [Internet]. Department of Defence, Canberra, 14 November 2008, available from <<http://www.defence.gov.au>> [accessed 14 November 2008].

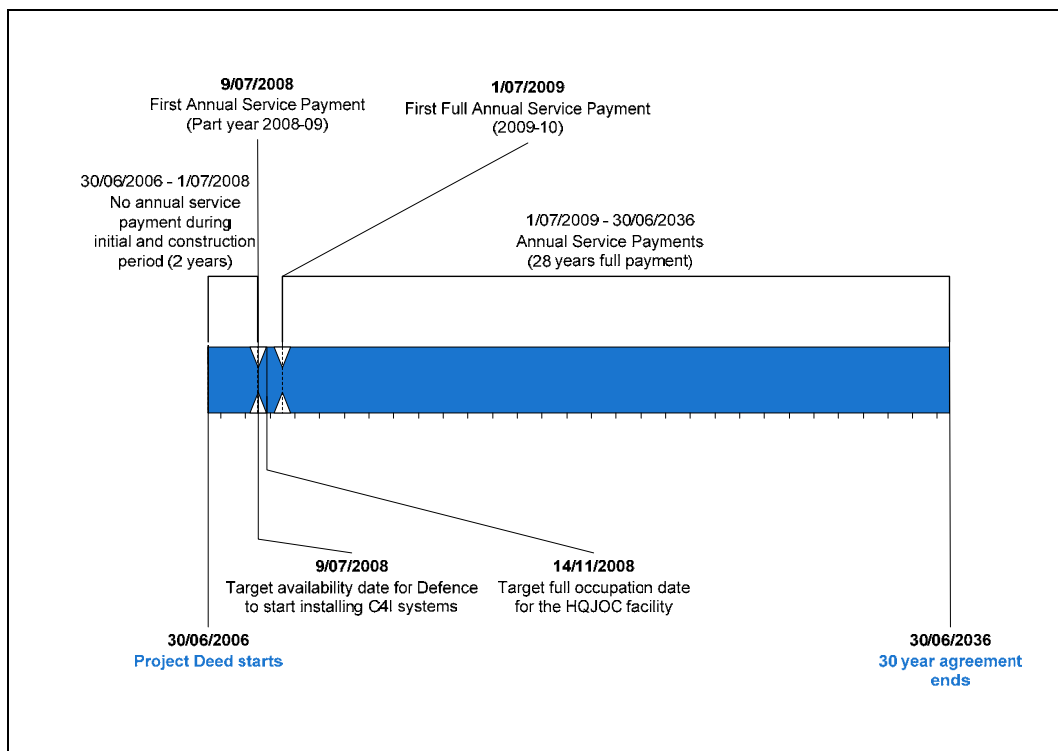
<sup>245</sup> An indicative base case financial model was prepared for commercial close in June 2006. The final base case and dollar value for the first full year annual service payment were prepared by the Prime Contractor in accordance with the agreed interest rate setting protocol in the Project Deed.

<sup>246</sup> If the invoice amount is disputed by Defence the disputed amount is able to be withheld by Defence and the Project Deed, clause 43, sets out dispute resolution procedures.

<sup>247</sup> The monthly service payments for July to November 2008 were to be at 78 per cent of the full monthly service payment.

**Figure 6.1**

**Timeline for HQJOC Project annual service payments**



Source: ANAO analysis.

**6.9** For simplicity, Figure 6.1 does not show the operation of the Project's retention fund. The retention fund begins 36 months before the scheduled expiry of the agreement and continues until the Project Deed expires or is terminated. Essentially, from this point the Project Deed provides for Defence to deduct ten per cent of the monthly gross services fee (before abatement) and pay this amount into an interest bearing account.<sup>248</sup> Subject to meeting specified conditions in the Project Deed, the Prime Contractor will receive a final payment from the retention fund.

<sup>248</sup> HQJOC Project Deed, Volume 1, Retention Fund, paragraph 39.1, p. 138.



## Impact of indexation

**6.10** The annual service payment is comprised of two components:

- capital (non-indexed annual service payment (NIASP)); and
- operating (includes an indexed annual service payment (IASP), and a non-indexed annual utilities payment).

The capital amount covers the construction capital, finance and tax costs, while the operating component represents whole of life payments for insurance and operation costs for items such as maintenance and security.

**6.11** As required in the Project Deed, the Prime Contractor sent the Financial Close Side Letter to the HQJOC Project Office on 28 July 2006 with confirmation of the dollar values (exclusive of GST, in 2006–07 prices) that form the basis of the annual services fee calculation as follows:

- Annual service payment (total) = \$38 295 178;<sup>249</sup>
- NIASP = \$26 782 368; and
- IASP = \$11 512 809.

**6.12** The annual service payment is indexed on 1 July each year during the term of the agreement according to a formula in the Project Deed, whereby, the annual service payment is the total of the NIASP and the IASP in the immediately preceding financial year—as multiplied by the division between the annual non-farm gross domestic product (GDP) implicit price deflator in the relevant financial years.<sup>250</sup> The operating component of the payment is further annually adjusted for inflation based on Consumer Price Index (CPI) figures provided to Defence by Finance.<sup>251</sup>

---

<sup>249</sup> The total does not include the non-indexed annual utilities payment (\$0.63 million) of the operating component.

<sup>250</sup> The ‘implicit price deflator for non-farm GDP’ is a measure of price change that is derived (hence the term implicit) by dividing gross non-farm product at current prices by gross non-farm product at constant prices. The Project Agreement references ABS Catalogue number 5206.0, table 41 for the March quarter of the relevant financial year.

<sup>251</sup> The CPI is a measure of change in the price of a basket of goods and services from a base period. Changes in the CPI are the most commonly used measure of inflation.

## **Financial model**

**6.13** Throughout the tender process, Defence requested that the tenderers present their financial models in a specific format. This included that the tenderers were to provide a printed version of the model and an electronic version compatible with Microsoft Excel 2000 and/or Defence systems. All amounts, unless specified otherwise, were to be in thousands of Australian dollars and exclusive of GST.

**6.14** In addition to the Project's Replacement Financial and Commercial Adviser providing advice to Defence on the operation of the tenderers' financial models, the Prime Contractor also submitted an independent report on the operation of its financial model, as part of the required RFRO response in January 2006. The same company performed a similar service for the Prime Contractor at financial close in July 2006. Both reports were positive in their findings as to the internal consistency and mathematical accuracy of the calculations in the financial model.

**6.15** During the audit, the ANAO:

- met with and discussed various aspects of the operation of the Prime Contractor's financial models with Defence and its advisers;
- was given access by Defence to printed and electronic versions of the financial models from the Prime Contractor and Consortium B; and
- attended a presentation on the operation of the Prime Contractor's financial model with Defence, at which representatives from the Project's Replacement Financial and Commercial Adviser during the tender process explained the operation of the model in more detail.

**6.16** The ANAO's audit team did not assess the detailed operation of any tenderer's financial model or the accuracy of any inputs to same. The Project's Original and Replacement Financial and Commercial Adviser and the relevant TEWGs assessed the tenderers' financial models during the tender process. The ANAO focussed on an analysis of the following:

- the annual service payments; and
- Defence's management of the Project's financial records.

## **Annual service payment advice to the Minister for Defence**

**6.17** Table 6.1 shows a comparison of the changes from the close of the RFRO on 19 January 2006 through to financial close on 28 July 2006 to

estimates of the total annual service payments payable under the Prime Contractor's ATR2.

**Table 6.1**

**Comparison of HQJOC annual service payments**

<b>Date</b>	<b>First full year of payment 2009–10<sup>A</sup></b> (\$million, 2006–07 Budget prices outturned, exclusive of GST)	<b>Estimated total annual service payments<sup>B</sup></b> (\$billion, 2006–07 Budget prices outturned, exclusive of GST)
<b>19 January 2006:</b> Prime contractor's ATR2 response to Request for Final Revised Offer.	38.08	1.22
<b>29 May 2006:</b> Defence advice to the Minister at the end of clarifying discussions with the preferred tenderer.	37.6	See Note C
<b>18 June 2006:</b> Defence advice to the Minister at the end of the negotiation phase with the Prime Contractor before commercial close on 30 June 2006.	37.68	1.18
<b>28 June 2006:</b> Defence advice to the Minister after most of the contract documents were signed on 23 June 2006.	39.85	See Note C
<b>30 June 2006:</b> Prime Contractor's financial base case at commercial close.	37.91	1.23
<b>28 July 2006:</b> Prime Contractor's revised (final) financial base case at financial close.	39.99	1.29
<b>9 August 2006:</b> Defence advice to the Minister after reaching financial close with the Prime Contractor on 28 July 2006.	39.99	1.26

Notes: (A) First full year of payment based on the IASP and NIASP components and an amount for the non-indexed annual utilities payment.

(B) The total payments to be made by Defence to the Prime Contractor from the first part-year payment in 2008–09 to the final payment in 2035–36 is an estimate due to the unknown impact of indexation factors over the period.

(C) An annual service payment schedule was not included in the advice to the Minister.

Source: ANAO analysis.

**6.18** Defence provided the Minister with the following advice about changes to the annual service payments listed in Table 6.1:

- **29 May 2006:** increase required to meet the 9 July 2008 target availability date;<sup>252</sup>
- **28 June 2006:** increase due to the impact of additional items being included in the Project, includes acceleration costs to meet the target availability date, and interest rate movements from 19 January 2006 (tender close) to 30 June 2006 (commercial close);<sup>253</sup> and
- **9 August 2006:** increase due to movements in the financial markets from 30 June 2006 (commercial close) to 28 July 2006 (financial close).

**6.19** Table 6.1 also shows a difference between the estimated total annual service payments at 28 July 2006 (\$1.29 billion) and 9 August 2006 (\$1.26 billion). Defence advised the ANAO that: ‘As a result of establishing the annual service payment during financial close and thus establishing the start point, Defence was then in a position to update the results for actual escalation treatment in August 2006’.<sup>254</sup> As previously described, two indices are included in the annual service payment calculation: non-farm GDP implicit price deflator and CPI (see footnotes 250–251). Defence further advised that, as at October 2008: ‘The estimated total of the annual service payments that Defence will pay is in the order of \$1280 million, excluding utilities and abatements’, due to further updates to the relevant indices.<sup>255</sup>

**6.20** Defence advised the Minister on 9 August 2006 that:

---

<sup>252</sup> See paragraphs 5.13–5.15 in Chapter 5 for details.

<sup>253</sup> A revised payment schedule with this information was emailed from Defence to Finance on 23 June 2006 and made available to the Minister for Finance and Administration with the draft letter of reply to the Minister for Defence, but the revised schedule does not appear to have been sent to the Minister for Defence on that day.

<sup>254</sup> Defence letter to the ANAO dated 22 October 2008.

<sup>255</sup> *ibid.*

The financial modelling also determined that the net present cost to Defence for the provision by [the Prime Contractor] of the buildings, infrastructure and services over the 30 year term to be \$572.2m, (2006–07 Budget prices outturned). The net present cost is divided into a capital component of \$234.57m for the buildings and infrastructure, an operating component of \$195.19m for the services, \$100.70m for finance costs, \$19.96m for taxation, \$13.59m for insurance and \$8.18m for utilities.

The amounts in paragraph 6.20 are paid to the Prime Contractor via the annual service payments.

## **Management of financial records**

**6.21** As an Australian Government agency, Defence's records are required to comply with a range of legislative, policy and legal requirements. The DPPM advises that: 'Documentation is critical to accountability and transparency. It provides a record of procurement activities and how they have been conducted, and facilitates scrutiny of them'.<sup>256</sup>

**6.22** During the audit, the ANAO accessed agency records for the Project in the form of paper and electronic documents from the following sources: Defence; Finance; Treasury; and the Project's Legal Adviser. These documents form the audit's evidence base for the report.

**6.23** The ANAO found that accessing the financial records for the Project and discussion of financial matters with the Project Office was a lengthy process, including for the core requirement that the Project demonstrate to the Government that VFM could be achieved using a PPP arrangement for the Project instead of direct procurement. A series of meetings was held to discuss financial matters with Defence including a meeting in August 2007 that was suspended when it was agreed that the Defence and Replacement Financial and Commercial Adviser's representatives present were unable to provide the required information. The meeting participants agreed to hold a further meeting to discuss financial matters that would include other advisers and previous members of the Project team, including the DG HQJOC Project.

**6.24** The management of records from the tender, particularly the financial records for the annual service payments and financial close documentation, is fundamental to ensuring the success of Defence's ongoing contract

---

<sup>256</sup> Department of Defence, op. cit., paragraph 224, p. 1.2.4.

management of the Project Deed for the 30 year life of the term.<sup>257</sup> Ideally, an effective contract would be complemented by retaining a number of core staff in the Project Office, particularly in the early years of contract management when payments to the Prime Contractor began post-construction in July 2008.

**6.25** Defence advised the ANAO in April 2008 that the tenure of the DG HQJOC Project for the tender process was from 19 January 2004 to 21 January 2007. The length of the appointment was designed to provide continuity and retain corporate knowledge about the Project during the tender management phase of the Project. Defence further advised that the continued presence of the same Chief of Staff and Director Infrastructure for both the former, and current, DG HQJOC Project supported continuity.<sup>258</sup>

**6.26** However, on a number of occasions in 2007, which the ANAO alerted Defence to, there was strong evidence that key knowledge about the financial matters for the Project had not been retained in the Project Office. At a key meeting to discuss the Project's financial matters in February 2008, it was the Replacement Financial and Commercial Adviser's representatives present who gave a detailed explanation to the ANAO of the operation of the Prime Contractor's financial model. The presentation was supplemented by advice from the former DG HQJOC Project.

**6.27** Defence later advised the ANAO that difficulties with the management of the Project Consultant's contract, whose role included contract administration and management services throughout the life of the tender, impacted upon the overall Project Office's management of its record keeping.<sup>259</sup>

**6.28** The ANAO also noted that a compliance audit of the Project's procurement process, performed at the end of the Project by the Project's Risk Management Adviser (see Chapter 3), did not assess the Project Office's record keeping activities against the *Archives Act 1983*. Instead, the audit focussed on:

---

<sup>257</sup> In accordance with the Project Deed, Schedule 1, Conditions Precedent, Clause 3.1(i), Defence has received from the Prime Contractor a printed and electronic version of the financial close base case, an independent report certifying the accuracy of the model and an interest rate setting protocol for determining the service fee as at financial close, which are all held in the Project Office.

<sup>258</sup> Emailed advice to the ANAO from the former DG HQJOC Project on 25 and 29 April 2008.

<sup>259</sup> Meeting between the ANAO and Defence on 3 November 2008.

'risks associated with the potential challenges to the tender evaluation process'.<sup>260</sup>

## Summary

**6.29** Based on Defence's advice and the audit team's experience during audit fieldwork, the ANAO has concerns that the records dealing with financial matters for the Project might not prove to be adequate for future contract management of the annual service payments over the term of the Project. To date, the Project Office has relied upon: the continued presence of two senior staff members; access to the DG HQJOC Project; and, an ability to call upon the Project's former external legal and financial advisers during the tender process to explain or supplement the Project Office's corporate records—all of which are factors that are likely to change in the future.

**6.30** The ANAO considered that the Project Office's reliance on external support impacted on its ability to respond in a timely manner to the ANAO's requests for documents and information during the fieldwork stage of the audit. The ANAO appreciated that the Project Office completed the tender in 2006 and has since focussed on a sizeable construction phase. However, while the ANAO accessed a considerable number of records for the audit, the ANAO could not be certain that all relevant records from the Project were taken into consideration in the preparation of this report.

**6.31** The success of future contract management for the facility depends on the Project Office's records management during the tender and the availability of experienced contract managers to administer the next 28 years of payments to the Prime Contractor. The effectiveness of these arrangements will influence whether or not VFM for the Project is actually realised.

**6.32** The ANAO suggests that there would be benefit for Defence in reviewing the records generated during PPP tender processes to:

- ensure that all records necessary to inform the future management of the contract have been appropriately collated and stored; and
- identify how records management arrangements could be strengthened for future PPP tenders.

---

<sup>260</sup> Capital Insight, op. cit., p. 3.



**6.33** The ANAO notes the potential assistance for agencies offered by Finance's suite of Financial Management Guidance publications about the nature of PPPs.<sup>261</sup> Additionally, the ANAO considers that PPP publications from Infrastructure Australia for the Council of Australian Governments will provide a further source of advice for Australian Government agencies seeking to use PPP arrangements.<sup>262</sup>

**6.34** Defence advised the ANAO, as part of the agency's response to the proposed audit report, that:

The HQJOC Project was complex with many facets requiring external specialists. It should be noted that Defence also relies on specialist advisers during traditional procurement arrangements but that the PPP arrangement being the first such arrangement for the Commonwealth Government required an increased level of external specialist support. These included financial and facilities management advisers to ensure financial matters and through life costs were accurately reflected in development of the PCB.<sup>263</sup>

---

<sup>261</sup> Available from the Department of Finance and Deregulation's website at < <http://www.finance.gov.au> >.

<sup>262</sup> Relevant PPP publications are available from Infrastructure Australia's website at <<http://www.infrastructureaustralia.gov.au>>.

<sup>263</sup> Defence letter to the ANAO dated 9 April 2009.

## 7. Probity Management

---

*This chapter describes the general approach to probity management for the HQJOC Project and discusses Defence's management of two significant probity issues that arose during the tendering phase of the Project.*

### Introduction

**7.1** Finance published advice in 2005 on probity in government procurement for Australian Government departments and agencies operating under the FMA Act.<sup>264</sup>

**7.2** Finance defines 'probity' as: 'Uprightness, honesty, proper and ethical conduct and propriety in dealings. Used by government to mean 'good process'.<sup>265</sup> In practice, probity management is used to:

- minimise conflicts/problems and the potential for litigation;
- avoid the potential for corrupt practices to occur;
- produce better outcomes against stated objectives; and
- maintain public sector integrity.<sup>266</sup>

**7.3** In this chapter, the role of probity in Australian Government procurement is described and compared with the probity process established for the Project. The remainder of the chapter is a discussion of Defence's management of two significant probity issues that arose during the tendering phase of the Project—a breach of confidentiality and of security. The discussion focuses on the confidentiality and security aspects of probity management.

### Probity guidance for Australian Government procurement

**7.4** While not legislatively mandated, Finance's 2005 *Guidance on Ethics and Probity in Government Procurement* (Finance's Probity Guidance) recommends

---

<sup>264</sup> Department of Finance and Administration, Financial Management Guidance No.14 *Guidance on Ethics and Probity in Government Procurement*, Finance, Canberra, January 2005.

<sup>265</sup> Department of Finance and Administration, Financial Management Guidance No.18 *Public Private Partnerships: Risk Management*, Finance, Canberra, December 2006, p. 54.

<sup>266</sup> Department of Finance and Administration, op. cit., p. 16.

that in procurement processes undertaken by FMA Act agencies, such as Defence, agencies should consider probity issues as integral to effectively managing all stages of a procurement process.

7.5 The general guidance and practical advice for more complex procurement processes contained in Finance’s Probity Guidance is to be read in conjunction with the *Commonwealth Procurement Guidelines* (CPGs).<sup>267</sup> The CPGs present the broad requirements for government procurement to be conducted in an ethical manner (see paragraphs 2.5–2.6 in Chapter 2 for a description of the CPGs). Specifically, the CPGs advise that: ‘Agencies need to ensure that officials involved in procurement, particularly those dealing directly with suppliers and potential suppliers consider seeking advice where probity issues arise’.<sup>268</sup>

7.6 Considered and successful probity management contributes to the achievement of efficient, effective and ethical use of Commonwealth resources in accordance with the FMA Act and ensures public accountability.

## Probity arrangements for the Project

7.7 In determining if a probity plan is useful for a particular procurement a number of factors need to be considered including:

- whether the procurement is of high value, or large in scale;
- the complexity of the procurement; and
- the potential sensitivity in the community to the project.

The presence or absence of some or all of these factors contributes to an assessment of the overall procurement’s risk for an agency. Probity plans are a means to identify and manage the specific probity risks.<sup>269</sup> Thus, given the size and complexity of the Project, the ANAO expected to find that Defence had considered probity management for the Project and had a documented plan or process in place before the tender began, which was then acted upon by the Project’s staff throughout the procurement process.

---

<sup>267</sup> Department of Finance and Administration, op. cit., p. 2.

<sup>268</sup> *ibid.*, p. 16.

<sup>269</sup> Australian National Audit Office 2007, *Better Practice Guide—Fairness and Transparency in Purchasing Decisions*, August 2007, ANAO, Canberra, p. 39.

## Probity adviser and probity plan

7.8 As discussed in Chapter 2, Defence appointed a Legal Process Adviser—the Australian Government Solicitor—for the Project. The Legal Process Adviser’s role was to: provide legal advice on the general conduct of the Project, including the development of project documents such as the evaluation procedures and methodology; and, act as the Project’s probity adviser, including establishing and maintaining a register of probity issues.

7.9 The Legal Process Adviser, as part of its role and in consultation with the Project’s other advisers, drafted a *Process Plan* (February 2005) for the conduct of the Project (also see paragraphs 3.5–3.6 in Chapter 3). The purpose of the *Process Plan* was to identify potential legal or probity risk issues that might arise as part of the tender process and establish a methodology to deal with those risks.<sup>270</sup>

7.10 The *Process Plan* contains advice under the headings of ‘Probity’ and ‘Security and Confidentiality’. Finance’s Probity Guidance identifies having appropriate security and confidentiality arrangements in place as one of six principles underpinning ethics and probity in a procurement process.<sup>271</sup> Schedule 2 of the *Process Plan*, ‘Security Protocols’, contains protocols for: security and distribution of secure information; control of communications with tenderers and other persons; and, removal and copying of secure information. The schedule was to be used in conjunction with Defence’s own procedures for securing confidential tender information.

7.11 The ANAO considers that to enable the management of security and confidentiality risks in procurement processes, agencies would need to have available to all staff appropriate, clear and current policy and guidance material.<sup>272</sup> In addition to the *Process Plan*, the ANAO noted that the following sources of guidance on ‘probity’ and ‘security and confidentiality’ for the Project were available:

- CPGs and associated probity advice from Finance;
- *Defence Security Manual* (the agency’s primary security reference document);

---

<sup>270</sup> Australian Government Solicitor, *Legal Process Adviser’s Report*, op. cit., p. 3.

<sup>271</sup> Department of Finance and Administration, op. cit., p. 18.

<sup>272</sup> Australian National Audit Office 2007, op. cit., p. 31.

- DPPM;
- HQJOC TEP. The final version of the TEP incorporated ‘Security Standing Orders’ for the Barn where the tender evaluations were conducted; and
- *Administrative Instruction: HQJOC Project Tender Evaluation*, detailing the administrative and logistical arrangements and responsibilities for the tender process (issued by the DG HQJOC Project on 10 February 2005).

The list is not exhaustive and would also include access to relevant Australian Public Service and Defence-specific legislation.

## **Probity and security briefings for project participants**

**7.12** The ANAO understands from reviewing the available Defence documents about the security and confidentiality arrangements for the Project that the Legal Process Adviser provided specific probity training, including modules on confidentiality and information security, to the Project’s participants.<sup>273</sup> This training was provided on a number of different occasions including at the first meeting of each TEWG and at the first meeting of the TEB and the PGB before evaluating responses to the RFT and RRO stages of the tender.<sup>274</sup>

**7.13** The TEPs further require that:

All members of the tender evaluation organisation must have signed a statutory declaration or conflict of interest disclosure statement (for Commonwealth or Australian Defence Force personnel) or deed of confidentiality and fidelity and conflict of interest disclosure statement (for advisers or other professional service providers) in a form set out in Annex D (or another form approved by the DG HQJOC Project) dealing with key probity requirements.<sup>275</sup>

**7.14** See paragraph 7.18 for Defence’s management of disclosure statements and deeds. A declaration of any ‘Conflict of Interest’ matters was a standing

---

<sup>273</sup> Table 3.1 in Chapter 3 contains the membership details of the Project’s various working groups and boards.

<sup>274</sup> See Chapter 2 for a description of the role of the TEWGs, TEB and PGB for the HQJOC Project.

<sup>275</sup> Department of Defence, *op. cit.*, p. 17.

item at all PGB and TEB meetings and a similar agenda item was included in the meeting records from a number of the TEWG meetings.<sup>276</sup>

**7.15** There was a further requirement in the TEPs and the *Administrative Instruction: HQJOC Project Tender Evaluation* that the Project's advisers, who were members of a TEWG, and any further external specialists, required a Defence RESTRICTED security clearance.<sup>277</sup> In March–April 2005, the DG HQJOC Project authorised the Defence RESTRICTED security clearance requirement to be waived for a maximum of eight weeks for a number of external advisers to the TEWGs. In the request seeking the delegated approval from the DG HQJOC Project for the waiver, it was stated that the waiver would only apply until a security clearance was obtained and that the affected personnel would be required to sign a 'Deed of Confidentiality and Fidelity' before accessing the tender documents.

**7.16** The ANAO considers that Defence took reasonable steps, commensurate with the available probity and security guidelines and the Project's size and complexity to ensure that participants involved in the HQJOC tender were aware of the Project's security arrangements, confidentiality requirements, and their individual responsibilities. If followed, by Defence and its advisers, the procedures appeared appropriate to ensure that the probity requirements for the Project could have been effectively managed for the procurement process.

### **Probity sign-off at the end of the Project**

**7.17** Chapter 3, paragraphs 3.66–3.68, discusses the post-tender evaluation reports for the HQJOC tender process provided by the Legal Process and Risk Management Advisers. As discussed in Chapter 3, both advisers provided overall positive reports about Defence's management of the HQJOC tender. The ANAO noted that the Legal Process Adviser documented conflict of interest matters in a Probity Register (connected to the Conflicts Register that

---

<sup>276</sup> No conflict of interest matters were declared at any of the PGB or TEB meetings. The meeting records assessed for the TEWGs also did not record any conflict of interest matters having been declared.

<sup>277</sup> In the first instance, only the DG HQJOC Project, the PGB and TEB, and the Financial TEWG members were to have access to the pricing details for the tender—on a 'need to know' basis. If required, additional access could be approved by the DG HQJOC Project.

was attached to its final report) and was notified of only one breach of the Project's confidentiality obligations (see paragraph 7.42).<sup>278</sup>

**7.18** One of the areas that was determined by Defence and its adviser to be out of scope for the Risk Management Adviser's audit was a: 'detailed review of the management of the security issues, including information security classification, information security, and access to premises where tender information is, and was, held.'<sup>279</sup> Defence advised the ANAO that this was because of a previous investigation of the Project's security arrangements by the Inspector-General's area, see paragraph 7.34.<sup>280</sup> However, the adviser's audit report identified the following probity related matters for the tender:

- three criteria in the ITR evaluation process were given a 'non-conforming' rating, that is, there was insufficient evidence available to demonstrate that the process had been carried out in accordance with the requirements for the process; and
- one criteria in the RFRO stage was rated as an 'observation', that is, subject to interpretation, or clarification required.

**7.19** Table 7.1 presents the relevant findings from the Risk Management Adviser's audit report (February 2007), Attachment A: Completed Audit Checklists.

---

<sup>278</sup> The Australian Government Solicitor (AGS), formerly the Project's Legal Process Adviser, advised the ANAO in April 2009, as part of the agency's response to the proposed audit report, that it had no record of its being provided with a copy of the Risk Management Adviser's *Audit of Procurement Process for the Headquarters Joint Operations Command Project*, February 2007. Therefore, AGS had not had an opportunity to review the probity related audit findings identified in that report. AGS letter to the ANAO dated 9 April 2009.

<sup>279</sup> Capital Insight, *Audit of Procurement Process for the Headquarters Joint Operations Command Project*, February 2007, p. 4.

<sup>280</sup> Defence letter to the ANAO dated 22 October 2008.

**Table 7.1**

**Summary of probity related audit findings identified in the Risk Management Adviser’s audit report, February 2007**

Compliance criteria	Audit finding
<p><b>Conflict of interest:</b> Have all evaluation personnel executed formal declarations of no conflict of interest prior to accessing Invitation to Register (ITR) responses?</p>	<p><b>Non-conforming:</b> Incomplete evidence of completion of Conflict of Interest (COI) declarations by all evaluation personnel. 15 out of 21 COI statements are on file. COIs are completed on various dates. While a process was established to ensure that COI declarations be completed prior to involvement in the ITR evaluation process – no direct evidence that all COIs were completed prior to involvement in the evaluation process was sighted during the audit.</p>
<p><b>Confidentiality:</b> Have all evaluation personnel executed individual confidentiality undertakings prior to assessing Invitation to Register (ITR) responses?</p>	<p><b>Non-conforming:</b> Incomplete evidence of confidentiality undertakings by all evaluation personnel. 13 out of 21 confidentiality undertakings are on file. Undertakings are completed on various dates. While a process was established to ensure that confidentiality undertakings be completed prior to involvement in the ITR evaluation process – no direct evidence that all confidentiality undertakings were completed prior to involvement in the evaluation process was sighted during the audit.</p>
<p><b>Recording Keeping:</b> Did all persons involved in the (ITR) evaluation process certify that hard and soft copies have been returned and that all copied electronic files have been erased?</p>	<p><b>Non-conforming:</b> Unlike the Request for Revised Offer (RFRO) process, there was no evidence of issue or return of hard and soft copies of documentation to persons involved in the evaluation process.</p>
<p><b>Probity:</b> Has the Legal Process Adviser provided the PGB, the TEB, TEWG Leader’s Group, the TEWGs and any Commonwealth advisers involved in the (RFRO) evaluation process with a probity presentation at the first meeting of each group?</p>	<p><b>Observation:</b> Completed, as noted in TEWG reports. However, for those personnel who did not attend the probity brief, but who commenced their involvement later in the evaluation process, a probity briefing was provided at the Barn by AGS personnel or by non-AGS personnel. However, while the project team have noted that these probity briefings were undertaken, and there is evidence that COI declarations were completed: there is no direct record of the completion of probity briefings at the Barn; and where the briefing was provided by non-AGS personnel, it is unclear whether the information provided was equivalent to the information intended to be provided by the Legal Process Adviser.  It is suggested that, for future reference, AGS (or Defence) establish a documented probity briefing for acknowledgement and sign-off by individuals who do not attend the AGS briefing session.</p>

Source: Risk Management Adviser, *Audit of Procurement Process for the Headquarters Joint Operations Command Project*, February 2007.



## Tender process—two significant probity matters

**7.20** The ANAO did not undertake a separate investigation of the two probity matters discussed in this section of the report. Rather, the ANAO conducted a documentary analysis of the available records, including two major reports produced by Defence in 2005.

**7.21** Two probity matters arose during the live stages of the tender—after the RRO closed on 3 June 2005 and before Defence issued the RFRO on 24 October 2005. Finance’s Probity Guidance recommends that agencies be aware that if a probity issue arises during a tender that consideration needs to be given to whether all tenderers can still receive fair and equal treatment if the tender continues. Sometimes, depending on the significance of the probity issue, it may be necessary to cancel the tender.<sup>281</sup>

### Breach of confidentiality arrangements for the Project

**7.22** Defence discovered a breach of the HQJOC Project’s confidentiality arrangements on 20 October 2005. The main pieces of information that were disclosed in breach of the confidentiality arrangements were a contractor security matrix and individual Design and Construct Contract Assessments for each of the tenderers, prepared as part of the tender’s commercial evaluation process. Defence’s *HQJOC Project Probity Review*, (November 2005) notes that: ‘a possible total of 34 persons ... were exposed to confidential project information without being authorised to do so by Defence’.<sup>282</sup>

#### *Defence’s management of the breach of confidentiality arrangements for the Project*

**7.23** Defence informed the Minister on 20 October 2005, the day the breach of confidentiality was discovered, of the matter and continued to advise the Minister on the progress of the matter until it was resolved in May 2006. The CDF and the Secretary of Defence were also informed of the matter on the first day.

**7.24** The Project Office initially contacted the members of the PGB on 23 October 2005 to alert them that a breach of confidentiality might have occurred with the Project and an out-of-session meeting might be required.

---

<sup>281</sup> Department of Finance and Administration, op. cit., p. 34.

<sup>282</sup> Department of Defence, *HQJOC Project Probity Review* (November 2005), p. 4.

The ANAO noted that the matter was subsequently discussed at PGB meetings held on 18 November 2005 and 16 February 2006. The PGB noted that, for probity and governance reasons, the Project Office did not have a formal role in the review process described in paragraph 7.25, other than providing relevant Project documents and information. The ANAO considers that Defence's level of involvement of the PGB for this matter was satisfactory.

**7.25** The Secretary of Defence established a Review Panel on 9 November 2005 to evaluate the information Defence had collected. The Review Panel conducted its investigation and a report was finalised on 18 November 2005. The 31 pages of the body of the report contained 12 findings.

**7.26** Defence acted in accordance with the HQJOC *Process Plan* and notified the Project's Legal Process Adviser of the breach of confidentiality arrangements.<sup>283</sup> The *Process Plan* also required the Project Office to report all breaches of security to the Defence Security Branch. Defence advised the ANAO that the DG HQJOC Project reported the matter directly to the then Deputy Secretary Defence Support Group, the Secretary and CDF, but not the Defence Security Branch.<sup>284</sup>

**7.27** Defence advised the Minister on 24 May 2006 that the matter had been fully concluded.

### *Potential impact on future Defence procurement*

**7.28** Paragraph 7.21 notes Finance's advice that agencies need to be aware that if a probity issue arises during a tender that consideration needs to be given to whether all tenderers can still receive fair and equal treatment if the tender continues. The way that agencies respond to probity issues and, equally as important, the way that agencies are perceived to respond, contributes to the extent that a probity challenge might impact on the agency's future procurement processes. For example, a lack of confidence in the security

---

<sup>283</sup> Defence also consulted with the Attorney-General's Department. The Project's Legal Process Adviser advised Defence by letter on 26 October 2005 that:

Legal Services Directions issued by the Attorney-General pursuant to section 55ZF of the *Judiciary Act 1903* require reporting of significant issues that arise in the provision of legal services to the Attorney-General or Office of Legal Services Coordination as soon as possible. In our view, the current circumstances clearly fall within the rubric of a significant issue.

<sup>284</sup> Defence letter to the ANAO dated 22 October 2008.

arrangements for a procurement process could potentially discourage prospective tenderers from responding to future tenders or result in a reduction in the detail or volume of information that tenderers are willing to provide in their tender responses.<sup>285</sup>

**7.29** The ANAO noted that Defence received advice in October 2005 from the Project's Legal Process Adviser that included options for dealing with the matter. However, the options did not explore the need to suspend the tender while the breach of confidentiality was being investigated. The extent of the breach of confidentiality and the effect it might have had on the tender was unknown at the time.<sup>286</sup> Furthermore, Defence did not formally record the outcome of any deliberations about whether or not suspending or cancelling the tender process was warranted. The ANAO suggests that, in future, it would be sound practice for Defence to formally record the outcome of any deliberations about the need to suspend or cancel a procurement process when major probity issues arise.

**7.30** As the tender process was not suspended during the investigation of the breach in confidentiality, there was no discernable effect on the overall timeframe for the Project. The content of the Project's *Process Plan* was written in sufficiently broad terms to cover eventualities such as the significant probity matter that occurred in October 2005. Defence's actions in response to the breach of confidentiality were in accordance with the requirements of the *Process Plan*.

#### *Defence's briefing of the tenderers*

**7.31** Acting on legal advice received, Defence and the Legal Process Adviser separately briefed the Prime Contractor, Consortium A and Consortium B on 24 February 2006 on the actions Defence had taken since advising the tenderers on 4 November 2005 of an apparent breach of confidentiality.

**7.32** Defence invited comments on the content of the briefing and received written responses from all three tenderers in March 2006 indicating, overall, that they were satisfied with the actions taken by Defence to address the matter. Therefore, records maintained by Defence indicate that no tenderer

---

<sup>285</sup> Australian National Audit Office, op. cit., p. 31.

<sup>286</sup> In the end, approximately one month elapsed between the breach occurring on 20 October 2005 and Defence's review panel finalising its report on 18 November 2005.

was disadvantaged by the breach of confidentiality that took place during the live tender for the Project.

### **Breach of security arrangements for the Project**

7.33 Paragraph 7.25 refers to the Review Panel that conducted an investigation of the breach of confidentiality as having finalised a report on 18 November 2005 containing 12 findings. Finding 11 from the review report was to produce a separate report on an alleged breach of the Project's security arrangements.

7.34 The Secretary of Defence referred Finding 11 to the then Inspector-General of Defence for action. The intention was for the Inspector-General to produce an early report that could be used to inform a decision by the Secretary as to whether a full investigation would be required. Defence informed the relevant party of the Inspector-General's review by letter on 2 December 2005.

7.35 At the briefing for tenderers in March 2006 (see paragraphs 7.31–7.32), Defence advised that, as a result of the Inspector-General's review, the administrative procedures at the Barn were 'tightened' and the Project's advisers received a further briefing on Defence's security requirements before the RFRO tender evaluation began in January 2006. In conclusion, it was stated that: 'Defence has no reason to believe that any HQJOC tenderers have been advantaged or disadvantaged in relation to this tender as a result of these matters'.

7.36 The ANAO noted that in the written responses Defence received from the consortia after the March 2006 briefing, none referred to the Inspector-General's review.

#### *Inspector-General's report recommendations*

7.37 The Inspector-General's report—Interim Report on Unauthorised Disclosure of Information from the Headquarters Joint Operations Command Project Tender Evaluation—finalised on 22 December 2005 stated that the security arrangements for the tender evaluation material held in the Barn were

such that anyone with physical access to the site could have removed material without the Project Office's knowledge.<sup>287</sup>

**7.38** Overall, the Inspector-General's review report of the unauthorised removal of tender documents from the tender evaluation site made 11 points in conclusion and five recommendations (three of which were multi-part), including some that referred to the Project's security arrangements.

**7.39** The available Defence records indicate that the Inspector-General discussed the review report with the Secretary on 22 December 2005, but there is no record of the meeting outcome.<sup>288</sup>

*HQJOC Project Office's response to the review*

**7.40** Defence documents indicate that a copy of the Inspector-General's report was sent to the Project Office, however, there was no record on file in the Inspector-General's Division or the Project Office of how or when the report was sent. Following discussion of the matter with Defence, Defence advised the ANAO that:

I [DG HQJOC Project] received from the Deputy Secretary Corporate Support a copy of the Defence Inspector-General's report into a probity/security of tender information incident that occurred during the Request for Final Offers tender evaluation, and implemented the recommendations in that report, in so far as they were required for the HQJOC Project, prior to the commencement of the Request for Final Revised Offers tender evaluation.<sup>289</sup>

**7.41** The ANAO noted that in reply to a February 2006 email to the Inspector-General's audit team from the DG HQJOC Project outlining the information security measures used and monitored at the Barn, the audit team acknowledges that the Project Office had addressed most of the recommendations in the review report.

**7.42** The DG HQJOC Project also emailed similar advice, to that provided to the Inspector-General's audit team, to the Chair of the PGB and the Chair of

---

<sup>287</sup> Within the Barn tender evaluation working group members and advisers had unrestricted access to: photocopiers; mobile phones; facsimile facilities; the ability to transfer data to removable media such as laptop computers and memory sticks; and, personal laptops that could be connected to the Barn's Local Area Network. A password was used to control access to the Internet and the Defence Restricted Network.

<sup>288</sup> Defence letter to the ANAO dated 22 October 2008.

<sup>289</sup> Defence email to the ANAO dated 28 November 2008.

the panel reviewing the Project's breach of confidentiality. The PGB meeting minutes from late 2005–early 2006 do not contain any specific reference to the separate Inspector-General's review having been discussed. Furthermore, the *Legal Process Adviser's Report* (final probity report for the Project) states that: 'Apart from the issues noted ...[breach of confidentiality]... AGS has not been notified of any breaches of any confidentiality obligations of any officers of the Commonwealth or its advisers'.<sup>290</sup>

## Summary

**7.43** The ANAO established the main sequence of events surrounding Defence's investigation of the potential unauthorised removal of tender documentation from the tender evaluation site. However, Defence's records for the security breach investigation are incomplete and do not clearly document the process followed and may also not be a complete record of all of the remedial steps taken by the Project Office after the investigation ended.

**7.44** Defence has not maintained a record of the following:

- The Secretary's apparent decision not to proceed beyond the Inspector-General's interim report with a further investigation, after the unauthorised removal of information from the Barn was confirmed.
- Why the Inspector-General's review was not discussed at a PGB meeting.
- Why the Legal Process Adviser was not informed about the Inspector-General's review.
- Advice to the relevant party about the outcome of the Inspector-General's review.

**7.45** The ANAO considers that the available records would make it difficult for Defence to draw any lessons learned from the handling of this matter for application to similar procurement processes in the future.

---



Ian McPhee  
Auditor-General

Canberra ACT  
19 May 2009

---

<sup>290</sup> Australian Government Solicitor, op. cit., p. 6.

# Appendices





## Appendix 1: Defence's Comments on the Proposed Report

1. The Headquarters Joint Operations Command (HQJOC) Project is the first Public Private Partnership (PPP) by the Australian Government for the construction and maintenance of a facility on a greenfield site. The project was complex, incorporating both PPP project delivery and a direct procurement for the Command, Control, Communication, Computing and Intelligence (C4I) systems. Notwithstanding the complexity of the project, it was delivered successfully on time and on budget. To date, the PPP acquisition and delivery model has demonstrated itself to be a successful model for the construction and delivery phases of the building and infrastructure components of this project.
2. Defence notes that the use of a PPP for the HQJOC Project offered superior value for money, albeit marginally, compared with the likely costs that would have resulted from the use of traditional procurement methodologies.
3. The report makes mention of some areas where further improvement can be made in the administration and delivery of such projects, and in particular, the need to ensure records management is appropriate and comprehensive, particularly concerning long term projects. Since the finalisation of contractual agreements for the construction and operation of the HQJOC facilities, Defence has implemented a number of initiatives focussing on improving records management. These include:
  - In 2008, the HQJOC Project implemented an electronic records management system to assist in standardising business processes and procedures and managing documentation for HQJOC and future PPP projects. Additionally, DSG has established the National Contract Administration and Management (NCAM) Directorate to provide support to the administration and contract management of complex projects.
  - In October 2008, Defence established the Defence Records Management Committee (DRMC), to define Defence records management requirements and oversight the implementation of a records management strategy, in order to improve Defence's

record management policies, systems and processes. As a result, the Directorate of Records Management Policy was established.

4. Defence notes that the complete financial arrangements with the Prime Contractor, including the annual service payment schedule, are accurately reflected in the HQJOC Project Deed. Defence considers that these documents, along with the records management actions noted above, will allow it to effectively manage the Project over its 30 year life.

## Appendix 2: Praeco Pty Limited's Comments on the Proposed Report

1. The report seems to conclude that overall the project involved a costly 2 year tender process that delivered only a slim margin of benefit relative to traditional procurement (some \$0.94m). I don't think we can support this overall conclusion for the following reasons:<sup>291</sup>
  - The Government's own raw PCB changed 4 times, reflecting output specifications that changed at least 3 times. Hence the winning tenderer submitted in total 3 fully underwritten tenders, supported by fully documented mark-ups and relevant technical drawings, documentations and plans. The significant costs associated with this process had to be recovered by the Consortium from the Project on Financial Close, and hence is reflected in the NPV of the winning tender. I doubt that the PCB included this cost, which is a cost of the process, not a cost of delivering through the PPP model.<sup>292</sup>
  - It was clear that the under-bidders were not able to accept certain project risks that Praeco did in fact accept and hence Praeco's offer represented the best VFM and least risk to the Government. The Government's PCB is meant to be risk adjusted<sup>293</sup>—ie the total cost should reflect the risks that the Government would not be able to transfer under a traditional procurement model. We query how Defence can have confidence in the risks that were priced into the PCB if they were not able to adjust the under-bidders tender for such risks.
  - There was significant uncertainty in relation to the tax risk during the whole tender as Div 250 was going through a public consultation process, but would not be legislated in time.

---

<sup>291</sup> ANAO comment: the specific reasons outlined are discussed generally in the report and do not, in our view, affect the overall audit conclusion (see paragraphs 35–36).

<sup>292</sup> ANAO comment: the components of the PCB are outlined in paragraphs 2.25–2.33. Tenderers' costs associated with participation in the PPP tender process were not relevant to the PCB.

<sup>293</sup> ANAO comment: there are two components to the PCB—the base cost PCB and the risk adjusted PCB as explained in paragraph 2.32. Further, the report discusses the adjustments Defence made to the VFM assessment of the second tenderer's RFRO response because of assessed risk pushback (see paragraph 3.64).

- It is not clear whether the final PCB was adjusted for base interest rate changes or not, whereas clearly Praeco's final financial model was.
  - The output specification was unclear, and created risks and uncertainties to the private sector that were ultimately reflected in our pricing.
2. Overall we would assert that the report should acknowledge that the "slim" margin of benefit reflected more the circumstances of the tender—difficult tax environment, scope changes, long tender process, difficult/complex project—than the fundamentals of the PPP model.
  3. The fact that contractual close was achieved in one month was seen as a very efficient process. This was achievable as significant negotiations and documentation actually took place prior to our being announced preferred bidder.<sup>294</sup>
  4. The report in para 35 concludes that "Defence pursued an open approach which informed tenderers of the estimated capital operating and maintenance costs"—we would probably assert that Defence's approach would not be considered "best practice" relative to other processes that we have been involved in.<sup>295</sup> A number of areas of improvement may be:
    - Ceasing the practice of continuing the bid process with 3 bidders for as long as possible—it seems that Defence could

---

<sup>294</sup> ANAO comment: the report acknowledges that Defence conducted negotiations and reached commercial close with the Prime Contractor one month after the announcement of the Prime Contractor as the preferred tenderer, which is a relatively short time for a complex project (see paragraph 18). Details of the clarifying discussions Defence held with the Prime Contractor prior to the announcement of a preferred tenderer are contained in paragraphs 5.6–5.17. Discussion of the negotiations between Defence and the Prime Contractor after the announcement of the preferred tenderer are contained in paragraphs 5.21–5.27.

<sup>295</sup> ANAO comment: the report characterises Defence's approach as 'open' on the basis that tenderers were provided with the raw PCB to assist them in developing their tenders. This is an approach that is consistent with the *National Public Private Partnership Guidelines* released by Infrastructure Australia in December 2008.

have made a decision much earlier on in the process to continue with only 2 bidders.<sup>296</sup>

- The very limited interaction allowed between the bidders and Department of Defence advisers/personnel to clarify the output specification led to none of the bidders meeting the benchmark costs in the first rounds of bids.<sup>297</sup>
- The lack of feedback from Defence regarding the acceptability of various options proposed by the bidders, and insistence on full documentation, resulted in substantial additional bid costs—which all had to be priced into the final financial model.<sup>298</sup>
- "established and followed probity management processes commensurate with the Project's size and complexity". We would assert that relative to other tender processes, the Department of Defence's probity framework was not best practice in delivering an interactive and efficient tender. We would encourage the Department of Defence to consult with various other PPP delivery units around Australia to develop a framework that is both sound and still enables a level of interaction between the client and tenderers that would assist in clarifying the client's requirements and output specification, as well as the desirability of certain options that might offer better value for money. In the absence of such interaction, bidders are not able to optimise their bids and provide a value for money outcome.

---

<sup>296</sup> ANAO comment: it is common practice to seek to maximise the benefit to the Commonwealth through maintaining competitive tension with qualified bidders, but it is the case that Commonwealth agencies are expected to have regard to the costs to industry of tender processes and also ensure that all tenderers receive fair treatment at all stages of the tender process.

<sup>297</sup> ANAO comment: public sector procurement requires that all tenderers be provided with the same information. The final outcome of the RFT for the HQJOC Project indicates that despite Defence's efforts a communication gap existed between the tender documents and Defence's expectations in relation to innovative solutions in response to the RFT. The report also notes that it was clear that tenderers' interpretations of the RFT output specification contributed significantly to the unsatisfactory outcome for Defence from the RFT (see paragraph 3.36). The ANAO encouraged Defence to evaluate its approach to fostering innovative tender responses to RFTs for any future PPPs, which could be of benefit to Defence by reducing the need for additional tender rounds (see paragraph 3.37).

<sup>298</sup> ANAO comment: Defence's briefing of the tenderers after every round is discussed in Chapter 3 of the report, for example, see paragraphs 3.39 and 3.49.

5. In addition we provided in our tender submissions a detailed response to the PCB a summary of which is reproduced below:<sup>299</sup>

As a key element in this competitive RFT process, Praeco acutely understands the importance of seeking to be competitive with the Commonwealth's Project Cost Benchmark ('PCB') that has been developed for HQJOC.

At an earlier stage of the RFT process, Praeco indicated to Defence concerns regarding the cost components contributing to the PCB and the basis upon which these components may have been costed. Praeco indicated the strong likelihood that this Standard Tender Response may be based on cost components that did not readily reconcile with the levels proposed by the Commonwealth through the PCB, after allowing for a reasonable risk allowance between the two sources of costings.

Praeco recognises the limitations that typically arise when developing a PCB for a complex project such as HQJOC. Praeco has now had the benefit of addressing the detailed issues associated with design and delivery of HQJOC that may have only been subject to reasonable assumptions for the PCB. The most significant of these issues are unlikely to have been able to be readily identified or contemplated by the Commonwealth or its advisers through development of the PCB as they have typically arisen through the challenging process of blending detailed design and operation and maintenance planning with the detailed requirements of the Output Schedules.

Praeco provides the information and analysis set out below with the expectation that it should assist the Commonwealth to better compare this Standard Tender Response with its PCB. The associated commentary reflects the significant detailed understanding the Praeco team has developed of the cost inputs and the requirements of the Commonwealth. Praeco has sought to identify where differences in approach, understanding and detail may lead to differing expectations and outcomes on various elements of the project.

---

<sup>299</sup> ANAO comment: it is common practice in Australia and internationally to utilise a public sector comparator, which in the case of the HQJOC Project Defence called the PCB, as a benchmark against which to evaluate the relative VFM of a PPP. As noted in paragraphs 7 and 2.36, Defence consulted with Finance and engaged external expert advisers to assist in the development of the PCB. Further, Defence reviewed the PCB in light of developments throughout the tender process (see paragraphs 2.36–2.37).

## Appendix 3: Glossary

Alternative Tender Response	<p>In addition to a Standard Tender Response (STR), tenderers were able to submit Alternative Tender Responses (ATRs), being a tender response that proposed a payment mechanism or risk allocation that did not meet the requirements of a STR.</p> <p>The Commonwealth could consider an ATR only if the tenderer had also submitted a STR, and the Commonwealth considered that the ATR fully described the advantages and disadvantages of the proposed payment mechanism or risk allocation, including any pricing advantages from the proposal, and included sufficient information to allow comparison of the ATR with STRs.</p>
Business case	<p>A proposal that describes the justification for pursuing a project according to a certain delivery option and establishes a value for money recommendation as to the most appropriate procurement approach. The business case also provides key details about the project, expected costs and the associated budget impact and is updated at key points throughout the project assessment stage.<sup>300</sup></p>
Commercial close	<p>Under a Public Private Partnership (PPP), the standard commercial (business) aspects of the agreement are finalised at contract signature (commercial close) between the public and private sector partners.</p>
Condition Precedent	<p>In contract law is a provision of a contract that suspends the coming into effect of a contract or a term of the contract unless or until a certain event takes place.</p>

---

<sup>300</sup> A number of the terms defined in the Glossary have been sourced from the Department of Finance and Deregulation's Financial Management Guidance series of publications for Public Private Partnerships.

Consumer Price Index	A measure of change in the price of a basket of goods and services from a base period. Changes in the Consumer Price Index are the most commonly used measure of inflation.
Condition Subsequent	In contract law brings a duty to an end, whereas a condition precedent initiates a duty.
Discount rate	The percentage rate applied to cash flows to calculate the present value of future cash flow streams to enable comparisons to be made between payments made at different times. The rate quantifies both the time value of the future cash flow streams and the risk of the relative cash flow streams.
Financial close	Under a PPP, the private sector partner's financiers wait until after the commercial close before settling the financial aspects of the transaction. The latter activity is called the financial close.
Greenfield	Undeveloped land.
Implicit price deflator for non-farm gross domestic product	A measure of price change that is derived (hence the term implicit) by dividing gross non-farm product at current prices by gross non-farm product at constant prices.
Net Present Cost	The equivalent cost at a given time of a stream of future net cash outlays (calculated by discounting the values at the appropriate discount rate).
Net Present Value	The future cash flows, discounted for timing and risk, less the cost of investing in the project calculated in terms of today's worth.
Output Specification	Explains the scope of services and minimum standards for the Headquarters Joint Operations Command (HQJOC) Project that the tenderers were expected to meet in their tender responses.



Outturned prices	Estimates adjusted to incorporate the expected rate of inflation.
Preferred tenderer	A tenderer selected to develop its proposal during the negotiation period in sufficient detail to enable the execution of the final contract.
Private financing	A form of procurement involving the use of private sector capital to wholly or partly fund an asset that would have otherwise been purchased directly by the public sector and which is used to deliver public sector outcomes.
Probity	Uprightness, honesty, proper and ethical conduct and propriety in dealings. Used by government to mean 'good process'.
Project Deed	The HQJOC Project Deed defines the provision of, and payment for, services over the project period. The term 'Project Deed' is used in this report to refer to the formal contract agreement between the Commonwealth and the Prime Contractor and includes a number of other associated deeds entered into by these parties.
Public Private Partnership	The Australian Government defines PPPs as a form of government procurement involving the use of private sector capital to wholly or partly fund an asset—that would have otherwise been purchased directly by the government—which is used to deliver Australian Government outcomes.
Public sector comparator	A benchmark against which the value for money of private sector bids are assessed. It is typically a cost estimate based on the assumption that assets are acquired by government through conventional funding and that government retains significant managerial responsibility and exposure to risk.

Standard Tender Response	<p>Each tenderer was required to submit a Standard Tender Response (STR). A failure by any tenderer to lodge a STR would automatically result in the Commonwealth rejecting all tender responses submitted by that tenderer.</p> <p>STRs were to contain a mark-up, where the tenderer considered a mark-up appropriate, of the Part 3 documents. (Part 3 contains the Project Deed, other contractual documents and Schedule 4 of the Project's Output Specification. The preferred tenderer would be expected to enter into a contract with the Commonwealth substantially in the form of the Project Deed.) Any alternative allocation of the risks associated with key contractual provisions of the Project Deed was required to be presented in an Alternative Tender Response and priced accordingly.</p>
Tender Evaluation Plan	Records the method by which tenders for a requirement will be evaluated, including the evaluation criteria and the relevant probity requirements.
The Barn	A high security building located in Defence Establishment Fairbairn in the Australian Capital Territory. The HQJOC Project used the Barn to conduct the tender evaluation.
Value for money	In the private financing context, value for money (VFM) is assessed through a comparative analysis of all relevant costs and benefits over the entire life cycle of a project. VFM is tested by comparing the outputs and costs of private financing proposals against a neutral benchmark, called the public sector comparator (referred to by the Department of Defence as the Project Cost Benchmark (PCB) in this report). The result is an assessment of which option delivers the required services to the public sector at the lower total cost, with consideration given to both qualitative (risk transfer) and quantitative (cost) measures.

## Series Titles

---

ANAO Audit Report No.1 2008–09  
*Employment and Management of Locally Engaged Staff*  
Department of Foreign Affairs and Trade

ANAO Audit Report No.2 2008–09  
*Tourism Australia*

ANAO Audit Report No.3 2008–09  
*Establishment and Management of the Communications Fund*  
Department of Broadband, Communications and the Digital Economy  
Department of Finance and Deregulation

ANAO Audit Report No.4 2008–09  
*The Business Partnership Agreement between the Department of Education, Employment and Workplace Relations (DEEWR) and Centrelink*  
Department of Education, Employment and Workplace Relations  
Centrelink

ANAO Audit Report No.5 2008–09  
*The Senate Order for Departmental and Agency Contracts (Calendar Year 2007 Compliance)*

ANAO Audit Report No.6 2008–09  
*Illegal, Unreported and Unregulated Fishing in the Southern Ocean*  
Australian Customs Service

ANAO Audit Report No.7 2008–09  
*Centrelink's Tip-off System*  
Centrelink

ANAO Audit Report No.8 2008–09  
*National Marine Unit*  
Australian Customs Service

ANAO Report No.9 2008–09  
*Defence Materiel Organisation—Major Projects Report 2007–08*

ANAO Audit Report No.10 2008–09  
*Administration of the Textile, Clothing and Footwear Post–2005 (SIP) Scheme*  
Department of Innovation, Industry, Science and Research

ANAO Audit Report No.11 2008–09  
*Disability Employment Services*  
Department of Families, Housing, Community Services and Indigenous Affairs  
Department of Education, Employment and Workplace Relations

ANAO Audit Report No.12 2008–09  
*Active After-school Communities Program*  
Australian Sports Commission

ANAO Audit Report No.13 2008–09  
*Government Agencies' Management of their Websites*  
Australian Bureau of Statistics  
Department of Agriculture, Fisheries and Forestry  
Department of Foreign Affairs and Trade

ANAO Audit Report No.14 2008–09  
*Audits of Financial Statement of Australian Government Agencies for the Period Ending June 2008*

ANAO Audit Report No.15 2008–09  
*The Australian Institute of Marine Science's Management of its Co-investment Research Program*  
Australian Institute of Marine Science

ANAO Audit Report No.16 2008–09  
*The Australian Taxations Office's Administration of Business Continuity Management*  
Australian Taxation Office

ANAO Audit Report No.17 2008–09  
*The Administration of Job Network Outcome Payments*  
Department of Education, Employment and Workplace Relations

ANAO Audit Report No.18 2008–09  
*The Administration of Grants under the Australian Political Parties for Democracy Program*  
Department of Finance and Deregulation

ANAO Audit Report No.19 2008–09  
*CMAX Communications Contract for the 2020 Summit*  
Department of the Prime Minister and Cabinet

ANAO Audit Report No.20 2008–09  
*Approval of Funding for Public Works*

ANAO Audit Report No.32 2008–09  
Management of the Tendering Process for the Construction of the Joint Operation Headquarters

ANAO Audit Report No.21 2008–09  
*The Approval of Small and Medium Sized Business System Projects*  
Department of Education, Employment and Workplace Relations  
Department of Health and Ageing  
Department of Veterans' Affairs

ANAO Audit Report No.22 2008–09  
Centrelink's Complaints Handling System  
Centrelink

ANAO Audit Report No.23 2008–09  
*Management of the Collins-class Operations Sustainment*  
Department of Defence

ANAO Audit Report No.24 2008–09  
*The Administration of Contracting Arrangements in relation to Government Advertising to November 2007*  
Department of the Prime Minister and Cabinet  
Department of Finance and Deregulation  
Department of Education, Employment and Workplace Relations  
Department of Health and Ageing  
Attorney-General's Department

ANAO Audit Report No.25 2008–09  
*Green Office Procurement and Sustainable Office Management*

ANAO Audit Report No.26 2008–09  
*Rural and Remote Health Workforce Capacity – the contribution made by programs administered by the Department of Health and Ageing*  
Department of Health and Ageing

ANAO Audit Report No.27 2008–09  
*Management of the M113 Armoured Personnel Upgrade Project*  
Department of Defence

ANAO Audit Report No.28 2008–09  
*Quality and Integrity of the Department of Veterans' Affairs Income Support Records*  
Department of Veterans' Affairs

ANAO Audit Report No.29 2008–09  
*Delivery of Projects on the AusLink National Network*  
Department of Infrastructure, Transport, Regional Development and Local Government

ANAO Audit Report No.30 2008–09

*Management of the Australian Government's Action Plan to Eradicate  
Trafficking in Persons*

Attorney-General's Department

Department of Immigration and Citizenship

Australian Federal Police

Department of Families, Housing, Community Services and Indigenous Affairs

ANAO Audit Report No.31 2008–09

*Army Reserve Forces*

Department of Defence

ANAO Audit Report No.32 2008–09

Management of the Tendering Process for the Construction of the  
Joint Operation Headquarters

# Current Better Practice Guides

---

The following Better Practice Guides are available on the Australian National Audit Office Website.

Developing and Managing Internal Budgets	June 2008
Agency Management of Parliamentary Workflow	May 2008
Public Sector Internal Audit	
An Investment in Assurance and Business Improvement	Sep 2007
Fairness and Transparency in Purchasing Decisions	
Probity in Australian Government Procurement	Aug 2007
Administering Regulation	Mar 2007
Developing and Managing Contracts	
Getting the Right Outcome, Paying the Right Price	Feb 2007
Implementation of Programme and Policy Initiatives:	
Making implementation matter	Oct 2006
Legal Services Arrangements in Australian Government Agencies	Aug 2006
Preparation of Financial Statements by Public Sector Entities	Apr 2006
Administration of Fringe Benefits Tax	Feb 2006
User-Friendly Forms	
Key Principles and Practices to Effectively Design and Communicate Australian Government Forms	Jan 2006
Public Sector Audit Committees	Feb 2005
Fraud Control in Australian Government Agencies	Aug 2004
Security and Control Update for SAP R/3	June 2004
Better Practice in Annual Performance Reporting	Apr 2004
Management of Scientific Research and Development Projects in Commonwealth Agencies	Dec 2003
Public Sector Governance	July 2003
Goods and Services Tax (GST) Administration	May 2003
Building Capability—A framework for managing learning and development in the APS	Apr 2003
Administration of Grants	May 2002

Performance Information in Portfolio Budget Statements	May 2002
Some Better Practice Principles for Developing Policy Advice	Nov 2001
Rehabilitation: Managing Return to Work	June 2001
Business Continuity Management	Jan 2000
Building a Better Financial Management Framework	Nov 1999
Building Better Financial Management Support	Nov 1999
Commonwealth Agency Energy Management	June 1999
Security and Control for SAP R/3	Oct 1998
Controlling Performance and Outcomes	Dec 1997
Protective Security Principles (in Audit Report No.21 1997–98)	Dec 1997