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Performance Audit

Implementation of Whole-of-Government Information Technology Infrastructure Consolidation and Outsourcing Initiative

Australian National Audit Office

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Australian National
Audit Office

Canberra ACT
6 September 2000

Dear Madam President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in accordance with the authority contained in the *Auditor-General Act 1997.* I present this report of this audit, and the accompanying brochure, to the Parliament. The report is titled *Implementation of the Whole-of-Government Information Technology Consolidation and Outsourcing Initiative.*

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

P. J. Barrett
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

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Abbreviations/Glossary

AAS	Australian Auditing Standards
ACCC	Australian Competition and Consumer Commission
AEC	Australian Electoral Commission
AGAL	Australian Government Analytical Laboratories
AGS	Australian Government Solicitor
ANAO	Australian National Audit Office
ATO	Australian Taxation Office
AUSLIG	Australian Surveying and Land Information Group
CMO	Contract Management Office
CN	Competitive neutrality
CPG	Commonwealth Procurement Guidelines
Cluster 3 CMO	Cluster 3 Contract Management Office
Cluster 3 MC	Cluster 3 Management Committee
DCF	Discounted cash flow
Defence	Department of Defence
DEETYA	Department of Employment, Education, Training and Youth Affairs
DEETYA/EN	Department of Employment, Education, Training and Youth Affairs and Employment National tender for IT&T services
DETYA	Department of Training and Youth Affairs
DEWRSB	Department of Employment, Workplace Relations and Small Business
DIMA	Department of Immigration and Multicultural Affairs
DISR	Department of Industry, Science and Resources
DoCITA	Department of Communications, Information Technology and the Arts
DOF	Department of Finance
DOFA	Department of Finance and Administration
DoTRS	Department of Transport and Regional Services

DSD	Defence Signals Directorate
EN	Employment National
EOS	Electoral Offices System
ESP	External service provider
FMA Act	Financial Management and Accountability Act 1997
FMV	Fair market value
Group 5 CMO	Group 5 Contract Management Office
ID	Industry development
IPP	Information Privacy Principle
IT	Information technology
ITSP	Invitation to Submit Proposal
IT&T	Information technology and telecommunications
LAN	Local area network
MIPS	Millions of instructions per second
NBV	Net book value
NCA	National Crime Authority
NPV	Net present value
OASITO	Office of Asset Sales and IT Outsourcing
OGIT	Office for Government Information Technology
OGO	Office for Government Online
PM&C	Prime Minister and Cabinet
Privacy Act	*Privacy Act 1988*
RFI	Request for information
RFT	Request for tender
SLA	Service Level Agreement
SME	Small to medium enterprises
TEC	Tender Evaluation Committee
WACC	Weighted average cost of capital
Y2K	Year 2000

Summary and Recommendations

Audit Summary

Background

1. This report contains considerable detail on a subject where there is a deal of inexperience, much learning for all concerned and differences in views on a range of complex issues and decisions, with the problems being accentuated by demanding time schedules. There is undoubted commitment by the range of parties involved to implement the Government's policy successfully. Nevertheless, there are also significant transaction costs involved, both direct and indirect, for all parties.

2. In the 1997-98 Budget, the Government announced the Whole-of-Government Information Technology Infrastructure Consolidation and Outsourcing Initiative (IT Initiative). The measure was directed at achieving long-term improvements in the structuring and sourcing of information technology (IT) services across agencies to facilitate greater integration in the delivery of programs and realise significant cost savings.

3. The IT Initiative is based upon a framework in which the information technology infrastructure and telecommunications (IT&T) requirements of Commonwealth agencies are gathered into a number of groups to be offered to the market. The overall strategy is to replace service delivery by agencies through component procurement with a service purchasing approach under which an external service provider (ESP) has end-to-end responsibility for delivering an integrated suite of services. This framework was expected to produce significant benefits, including financial savings in ESP charges; reduced tender costs to Government and industry; increased opportunities for rationalisation and standardisation between agencies; and efficiency in contract management. The IT Initiative was also seen as an opportunity to enhance the IT&T industry in Australia, particularly in regional areas.

4. The focus of this performance audit is on the implementation by Commonwealth entities of the Government's policy on IT consolidation and outsourcing. The extent to which a number of the Initiative's broader objectives are achieved will take some time to assess. At the commencement of this audit in March 1999, only four of the originally planned eleven tenders had been completed. Nevertheless, there are some important lessons to be learnt from experience to date, even though it is still too early to make a complete assessment of the overall impact of full implementation.

5. In anticipation of savings being realised from whole-of-Government IT consolidation and outsourcing, reductions were made to the forward estimates of Budget-funded agencies in the 1997-98 Budget. The reductions totalled $37.9 million in 1998-99, $87 million in 1999-00, and on-going annual reductions in agency budgets of $99.2 million from 2000-01. The Budget reductions were based on the conclusions of a 1997 evaluation of IT consolidation and outsourcing conducted jointly by the (then) Office for Government Information Technology (OGIT) and Department of Finance (DOF). If specific tender processes result in savings in excess of these reductions, the additional savings are retained by agencies. If the tender processes result in lower savings, agencies must fund the difference internally. In 1997, the Government estimated that the IT Initiative would result in savings of approximately $1 billion over seven years.[1]

6. As at June 2000, six of the twelve[2] major tenders now planned under the IT Initiative had been completed, with five resulting in executed Agreements. Full services had commenced under three of those Agreements. These were for the provision of IT&T services to Cluster 3[3], the Australian Taxation Office (ATO) and Group 5[4]. The total value of the three contracts is $732 million, comprising $157 million[5] for Cluster 3, $487 million[6] for ATO and $88 million[7] for Group 5. The Department of Employment, Education, Training and Youth Affairs (DEETYA) and Employment National (EN) tender (DEETYA/EN) was discontinued on 11 June 1998. These were the four tenders reviewed in this audit.

Audit approach

7. The objectives of the audit were to examine the administrative and financial effectiveness of the implementation of the IT Initiative, with

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1 Media Release, Minister for Finance and Administration, 67/97, 7 November 1997.

2 Eleven tenders were originally planned. Twelve major tenders will now be held due to the discontinuation of the 1998 DEETYA/Employment National (EN) tender, and the planned re-tendering of the non-EN services as part of Group 11.

3 Cluster 3 comprises the Department of Immigration and Multicultural Affairs (DIMA); the Australian Electoral Commission (AEC); IP Australia; Australian Surveying and Land Information Group (AUSLIG); Australian Government Analytical Laboratories (AGAL); Ionospheric Prediction Services; DOFA for the Electoral Offices System (EOS) ; and former bureau customers of DOFA, including the National Crime Authority (NCA).

4 Group 5 comprises the Department of Industry, Science and Resources (DISR); the Department of Communications, Information Technology and the Arts (DoCITA); the Department of Transport and Regional Services (DoTRS); the Department of the Prime Minister and Cabinet (PM&C); and the Australian Competition and Consumer Commission (ACCC).

5 In 1998-99 prices.

6 In 1999-2000 prices.

7 In 1999-2000 prices.

the focus being on the first four tenders conducted as outlined in paragraph 6. Accordingly, the audit assessed:

- the effectiveness of the overall planning and implementation of the IT Initiative, taking into account the tendering, contracting and monitoring processes undertaken in respect of Cluster 3, DEETYA/EN, ATO and Group 5;
- the extent to which those latter processes have contributed to the achievement of the objectives of the IT Initiative; and
- the extent to which the Commonwealth's interests have been adequately protected within this context.

8. The focus of the audit was on the overall management of the implementation of the IT Initiative by the Office of Asset Sales and IT Outsourcing (OASITO); the tendering process of the first four major tenders completed—Cluster 3, DEETYA/EN, ATO and Group 5 (including the application of the evaluation criteria set out in the relevant Requests for Tender (RFT) and the assessment of tenderers against the particular Government objectives as set out in the RFT); and on the management by the relevant agencies of the resulting Agreements. All four tenders considered by the audit were either completed or already in tender evaluation at the time of a December 1998 letter in which the Prime Minister advised all Portfolio Ministers that *'as a general Government policy, outsourcing of IT infrastructure services should proceed unless there is a compelling business case on a whole-of-Government basis for not doing so'*.

Overall conclusion

9. Implementation of the IT Initiative has involved significant effort on the part of OASITO and participating agencies. It involves the tendering of an unprecedented volume of business to industry in a limited period of time. Shortfalls in expected industry capacity and participation have been a significant factor in the need to revise and extend the implementation schedule. Implementation of the Initiative by OASITO is now expected to be completed in 2001, some two years after the initial date; and to cost nearly three times as much as was originally budgeted.

10. The outsourcing Agreements considered in this audit have operated for relatively short periods and their longer-term effectiveness in delivering the expected service and financial benefits will be determined over their five year terms. The extent to which those benefits have been realised by agencies in their initial implementation phases has been variable. Considerable progress has been achieved across a number of areas of importance to the Cluster 3 agencies, albeit with significant service delivery difficulties for extended periods. Operational services were generally delivered to expected levels by the ATO ESP as from handover in late June 1999, but there were significant levels of service instability following the handover to the Group 5 ESP in July 1999.

11. In each tender reviewed, the successful tenderer: offered the lowest price by a clear margin compared to that of other tenderers; was assessed as either preferred or comparable in terms of service and risk; and proposed industry development (ID) commitments that were assessed as adequately meeting the Government's ID objectives as set out in the RFTs. In each case, the tender evaluation reported actual and/or potential service benefits from the solution proposed by the successful tenderer, and identified a level of savings expected to accrue from outsourcing.

12. Australian National Audit Office (ANAO) considers that the financial evaluation methodology applied in these tenders did not allow for two key factors which, in ANAO's view, were material to the assessment of savings arising from outsourcing the relevant IT&T services. The evaluations did not consider the service potential associated with agency assets expected to be on hand at the end of the evaluation period under the business-as-usual case, or the costs arising from the Commonwealth's guarantee of ESP's asset values under the outsourcing case. Consequently, the savings realisable by agencies from outsourcing, as quantified in each tender evaluation, were overstated. Adjustments identified by ANAO resulted in material changes to the savings reported in the ATO and Group 5 financial evaluations. At the point of selection of the Group 5 preferred tenderer, these adjustments resulted in no savings being identified at either the agency level, or after the application of notional competitive neutrality (CN) adjustments. That said, it is important to note that the Government's objectives in pursuing the IT Initiative were broader than the achievement of savings, as outlined in paragraphs 2 and 3 above.

13. The Cluster 3, ATO and Group 5 Agreements cover the provision to agencies of a range of IT&T services and associated equipment. In respect to the provision of that equipment by the relevant ESPs, the Commonwealth has entered into a series of finance lease transactions, rather than operating leases as was envisaged. Under these finance leases, substantially all the risks and benefits of ownership of the relevant assets have been retained by the Commonwealth.

14. Agency budgets and forward estimates were reduced at the inception of the IT Initiative to take account of the savings envisaged from the IT Initiative. Agencies were required to deliver the predetermined level of savings or, alternatively, fund the budget reductions from other agency sources. Because of changes which have occurred in agency cost structures since the Government's decision, and during the course of the letting of tenders and their evaluation, it is not possible to measure, with precision, the extent of actual savings released or contributed by the IT Initiative. However, after excluding savings identified in respect of services not considered in the calculation of agency Budget reductions[8], the aggregate relative savings in agency cash outlays projected under the Cluster 3, ATO and Group 5 tender evaluations represented about four-fifths of total reductions to those agencies' budgets for the relevant five year periods and lines of service. However, there were marked differences in the level of budget savings realised in the tender evaluation at the agency level. Further, analysis by the Cluster 3 Contract Management Office (Cluster 3 CMO) suggested that cost savings were realised by Cluster 3 agencies in the first year of operation at about 80 percent of the rate forecast in the tender evaluation for the corresponding period and costs.

15. Based on the experience of Cluster 3, ATO and Group 5, ANAO concluded that key areas on which agencies should place particular focus in order to enhance the efficiency and effectiveness of IT outsourcing arrangements include:

- identification and management of 'whole-of-contract' issues, including retention of corporate knowledge, succession planning, and industrial relations and legal issues;
- the preparation for and management of, including expectations from, the initial transition to an outsourced arrangement, particularly where a number of agencies are grouped under a single Agreement;
- putting in place a management regime and strategy that encourages an effective long-term working relationship with the ESP, while maintaining a focus on contract deliverables and transparency in the exercise of statutory accountability and resource management requirements;
- defining the service levels and other deliverables specified in the Agreement so as to unambiguously focus the management effort of both the ESP and agencies on the aspects of service delivery most relevant to agencies' business requirements; and
- the ESP's appreciation of, and ability to provide, the performance and

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8 That is, voice telecommunications and applications development and maintenance services. The costs and potential savings associated with these services were not considered in the 1997 DOF/OGIT Evaluation on which the reductions to agency forward estimates made in the 1997-98 Budget were based. Inclusion of these services in the competitive tender process under the IT Initiative is optional for agencies.

invoicing information required by agencies to support effective contract management from both a performance and accountability viewpoint.

Initiative management

16. The original timetable for the IT Initiative required implementation to be completed by June 1999, but only four of the eleven major tenders originally planned were completed by that date. Initial planning for the IT Initiative drew on advice received from industry participants in the OGIT/DOF evaluation phase regarding intended participation in the IT Initiative. However, industry interest in participating in tenders under the IT Initiative, and its capacity to absorb the volume of tendering activity being undertaken, has varied from that originally expected. This has been a significant factor in the need to revise and extend the implementation schedule for the Initiative in order to improve the competitive environment for each tender. A revised implementation schedule extending the Initiative to December 2000 was announced in December 1998. As at June 2000, at least four of the remaining tender processes were unlikely to be completed by December 2000.

17. This extended timeframe has resulted in a mis-match between the timing of competitive tendering processes under the IT Initiative and the reduction of agency budgets in anticipation of savings being generated through outsourcing. For some agencies, budget reductions will have been in effect for up to two years before the competitive tendering process is complete.

18. The experience gained through the implementation of the IT Initiative has highlighted the importance of on-going market surveillance to support the strategic planning of IT tendering activities. Experience also suggests that, within the policy context, there are areas in which the structure of agency groupings could be enhanced to better support agency business requirements, including in terms of the relative size, business-focus, funding arrangements and security requirements of grouped agencies. Such recognition and flexibility might also provide greater scope for enhancing business performance, as well as achieving the expected whole-of-Government benefits. Overall performance is likely to be enhanced where strategies are complementary and action is mutually supportive of required outcomes.

19. As at May 2000, six major tenders had been completed, and considerable preparatory and/or evaluation work had been undertaken by OASITO and relevant agencies on a number of other tenders. Contracts representing the provision of about $1.2 billion in IT&T services over five years had been executed, with the Group 1 tender in tender evaluation and the Group 9, 10, 11 and Defence portfolio tenders at various stages of preparation and RFT development. The expected costs to OGIT/OASITO of implementing the IT Initiative have increased nearly threefold over the $13 million originally budgeted. Estimated overall Initiative implementation costs to May 2000 amounted to at least $40.38 million, or about 3.4 percent of the value of contracts awarded to that time. This was comprised of direct costs to OGIT/OASITO of $33.17 million (including advisers' fees and expenses of $25.78 million), and agencies' direct costs of participating in the Cluster 3, DEETYA/EN, ATO and Group 5 tenders of $7.21 million. These implementation costs include costs incurred by OASITO <u>for other tenders completed or in progress or preparation</u> as at May 2000, but excludes participation costs incurred by agencies involved in tenders other than those considered in this audit.

20. Payments to the Strategic Adviser to the IT Initiative accounted for over 60 per cent of OGIT/OASITO's total expenditure on advisers to May 2000. For the period June 1996 to June 1998, the Strategic Adviser was paid fees and expenses of $7.18 million to provide services in respect of the development and implementation of the IT Initiative. These assignments were not competitively tendered by OGIT, with the reasons for this not being documented. The then incumbent Strategic Adviser was re-appointed for six months to 31 December 1998 following a competitive tendering process undertaken by OASITO in May 1998. Fees were to be paid at the rate of US$85,000 per month (A$1.7 million per annum) for a partner-level adviser and US$65,000 per month (A$1.08 million per annum) each for two other advisers. The six-month engagement has been extended on a number of occasions, with additional full-time advisers added, and was still in operation in July 2000.

Tender outcomes

21. In each tender reviewed, cost savings and ID were identified as the Commonwealth's primary objectives. The Cluster 3, ATO and Group 5 RFTs stated that the Commonwealth would not award a contract unless it were satisfied that the preferred tenderer would deliver a substantial and acceptable level of cost savings based on an assessment against the criteria specified in the RFT. The terms 'cost savings', 'substantial' and 'acceptable' were not specifically defined.

22. The manner in which the requirement for cost savings was expressed in the RFTs meant that it was a key factor to be applied in the evaluation process. There was potential for the Prime Minister's December 1998 policy statement to be interpreted and applied in the evaluations in train at the time, that is ATO and Group 5, in a manner inconsistent with the selection preconditions set out in the respective RFTs. In those circumstances, there is a heightened need for the factors considered in any decision to award a contract in respect of a tender process to be appropriately documented/recorded. However, it is unclear to ANAO from the available evaluation documentation whether the December 1998 policy statement was considered in the ATO and Group 5 evaluations, and if so, how. ANAO considers that the transparency and accountability of the decision making process in the ATO and Group 5 tenders would have benefited from improved documentation/recording of the respective evaluation Committees' conclusions and advice as to whether the preconditions stipulated in the RFT had been satisfied by the recommended preferred tenderer, and the factors considered in reaching that conclusion. Future IT outsourcing tender processes would also be enhanced by incorporating into the tender planning process consideration of the means by which tenderers will be ranked in terms of the best combination of identified criteria.

Financial evaluation methodology

23. The financial evaluation undertaken in each tender reviewed identified the direct financial savings to agencies from outsourcing by comparing the projected cash flows associated with tenderers' bids with the projected baseline of business-as-usual cash outlays by agencies over a five year evaluation period. After the savings in agency cash outlays attributable to each tenderer had been calculated, notional CN adjustments were added to the agency cost baselines. These adjustments related to costs faced by private sector providers (and therefore reflected in their prices) that public sector agencies were not subject to, such as a requirement to earn a commercial rate of return on capital and the payment of wholesale sales tax and payroll tax. Together with the direct agency financial savings, the notional CN adjustments were then reported as post-CN savings.

24. ANAO examined the methodology used to assess the financial value to the Commonwealth of entering into the outsourcing arrangements consistent with Government policy. Using a variation of that methodology, which the ANAO considers necessary to more accurately reflect the savings arising from the outsourcing transactions, ANAO derived different levels of savings (see Figure 1). The variation applied to the treatment of end-of-period assets in calculating direct financial savings to agencies; and to the rate of return on assets imputed to agency costs in calculating the notional CN savings.

Figure 1

Comparison of tender evaluation and ANAO analysis of financial and notional competitive neutrality savings at selection of preferred tenderer

Direct financial cost savings to agencies at selection of preferred tenderer[8]:	Cluster 3		ATO[2]		Group 5	
	Nominal $m	NPV[1] $m	Nominal $m	NPV[1] $m	Nominal $m	NPV[1] $m
***Tender evaluation agency financial savings* (A)**	***62.03***	***49.94***	***60.44[3]***	***47.10[3]***	***0.96***	***0.17***
Less ANAO estimated adjustments (See Figure 7.3):						
• Fair market value of agency end-of-period assets[4]	(3.83)	(2.67)	(18.76)	(12.77)	(5.49)	(3.74)
• Cost of net Commonwealth obligation for end-of-period ESP assets[5]	2.60	1.79	(12.85)	(8.75)	(2.62)[6]	(1.78)[6]
***Estimate of revised agency financial savings* (B)**	***60.80***	***49.06***	***28.83***	***25.58***	***(7.15)***	***(5.35)***
Estimated financial savings variance ((C) = (A)-(B))	(1.23)	(0.88)	(31.61)	(21.52)	(8.11)	(5.52)
Revised agency financial savings as % of cost baseline	27.8%	27.6%	5.1%	5.6%	(7.3%)	(6.8%)

Notional savings at selection of preferred tenderer after competitive neutrality (CN) adjustments:	Cluster 3		ATO[2]		Group 5	
	Nominal $m	NPV[1] $m	Nominal $m	NPV[1] $m	Nominal $m	NPV[1] $m
Tender evaluation notional post-CN savings	***95.24***	***77.08***	***95.06***	***74.74***	***8.30***	***6.02***
Less ANAO estimated adjustments (see Figure 7.4):						
• Agency financial savings variance (see C above)	(1.23)	(0.88)	(31.61)	(21.52)	(8.11)	(5.52)
• Exclude return applied to turnover	(22.39)	(18.27)	n/a	n/a	n/a	n/a
• Asset risk premium reduction[7]	(2.08)	(1.50)	(9.99)	(7.95)	(1.47)	(1.15)
Estimate of revised notional post-CN savings	***69.54***	***56.43***	***53.46***	***45.27***	***(1.28)***	***(0.65)***

Note 1: Net present values (NPV) calculated at a discount rate of 8 percent.
Notes 2 to 6: See Notes 2 to 6 Figure 7.3
Note 7: Revised rate of return calculation based on Commonwealth bond rate plus a 3 percent risk premium. Consistent with the methodology applied in the tender evaluations, a nominal rate was applied for Cluster 3 and the ATO, and a real rate for Group 5.
Note 8: The analysis in this table does not include the cost to Commonwealth agencies of implementing the IT Initiative (see Figure 3.1).

Source: Cluster 3, ATO and Group 5 IT Services Evaluation Reports & cost models and ANAO analysis

25. The Cluster 3, ATO and Group 5 Agreements cover the provision to agencies of a range of IT&T services and associated equipment. ANAO analysed the contractual arrangements in the Cluster 3, ATO and Group 5 Agreements for dedicated equipment leased to agencies by the respective ESPs, and concluded that the economic substance of the transactions is that, in each case, the leases constitute finance leases rather than operating leases.

26. Under these finance leases, tenderers' capital risk on assets is substantially transferred to the Commonwealth such that, in normal circumstances, they are not exposed to financial losses on relevant assets.[9] This is reflected in lower lease pricing within the evaluation period than would otherwise have been tendered, but the ATO and Group 5 financial evaluations did not include due recognition of the costs associated with the Commonwealth's contractual obligations in respect of those leased assets. The Commonwealth exposure arises from the probable financial costs of technical obsolescence of IT assets and diminished service potential, which are not borne by the tenderers. The methodology applied in the Cluster 3 evaluation overstated this cost to the Commonwealth. The evaluation methodology applied in each tender also did not include due recognition of the residual value of agency assets at the end of the evaluation period. Consequently, the direct financial savings from outsourcing achievable by agencies, in comparison to retaining internal delivery, were overstated.

27. ANAO identified estimated adjustments to the quantified financial savings reported in each tender to account for the service potential associated with agency assets expected to be on hand at the end of the evaluation period under the business-as-usual case, or the costs arising from the Commonwealth's guarantee of ESP's asset values under the outsourcing case.[10] The aggregate effect of those adjustments indicated that the direct cost savings to agencies reported at the selection of preferred tenderer were overstated in the Cluster 3 tender by an estimated $1.23 million or 2 percent ($0.88 million in net present value (NPV) terms), and $31.61 million or 52 percent (NPV $21.52 million) for the ATO. At the same stage, the Group 5 tender evaluation projected direct cost savings to Group agencies of $0.96 million (NPV $0.17 million) over five years. The estimated adjustments identified by ANAO result in a projected 7.3 percent net cost of $7.15 million (negative NPV $5.35 million) to the Group agencies from outsourcing rather than financial savings (see Figure 1).

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9 Refer *DASFLEET Sale*, Audit Report No.25 1998-99, p.4 and pp 49-54.

10 In view of IT assets' high rate of obsolescence, ANAO's analysis was based on the assumption that fair market value of agency and ESP assets would represent half their estimated net book value at the end of the evaluation period.

28. The notional savings in each tender after the application of CN adjustments were also overstated. The largest component of the CN adjustments made in each tender related to the calculation of a return on agency assets. To calculate the notional return required in each case, OASITO applied a weighted average cost of capital (WACC) for the IT outsourcing industry. The WACC applied incorporated an allowance for equity capital return. However, in view of the Commonwealth's underwriting of tenderers' capital risk on dedicated assets (as discussed in paragraphs 25 and 26) and the commensurately reduced lease pricing offered by tenderers as a result of the lower risk profile, ANAO considers that the CN rate of return adjustment applied to the agency cost baseline should have reflected a lower rate of return requirement. This would have provided a more soundly-based comparison with the conditions on which the tenderers' pricing was based. Revised indicative CN adjustments for a required rate of return on agency assets calculated by ANAO based on the Commonwealth bond rate plus a 3 percent risk premium[11] significantly reduced the notional CN savings attributed to each tender. The Cluster 3 notional CN savings were also significantly overstated due to the application of the WACC to total agency costs rather than to assets (see Figure 1).

Budgetary cost savings

29. For a variety of reasons, it is difficult to draw direct parallels between the savings identified in the individual tender processes, and the reductions made to agency forward estimates in the 1997-98 Budget in anticipation of savings being realised from whole-of-Government IT consolidation and outsourcing. This difficulty increases with the passage of time between the announcement of the IT Initiative and the conduct of each tender. In particular, the financial evaluations conducted did not quantify the extent to which agencies may have improved internal efficiency in preparation for the tender process. They also included services not considered in the calculation of the agency budget reductions applied in respect of the IT Initiative, particularly voice telecommunications and applications development and maintenance services.

30. After excluding projected savings identified in respect of those services, the aggregate relative savings in agency cash outlays projected in the Cluster 3, ATO and Group 5 tender evaluations represented about four-fifths of total reductions to those agencies' budgets for the relevant

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[11] This is the typical target rate of return for low risk businesses identified by the Productivity Commission.

five year periods and lines of service. Total agency cash budget reductions over the relevant five year periods exceeded projected relative agency savings in cash outlays under the respective Agreements by $24.6 million. However, there was significant variability in the extent to which the direct agency savings calculated in the context of the Cluster 3, ATO and Group 5 tenders corresponded with the reductions to agency budgets.

31. Expected savings for Cluster 3 were over one and a half times the reductions to agency budgets. Analysis by the Cluster 3 CMO suggested that cost savings were realised by Cluster 3 agencies in the first year of operation at about 80 percent of the rate forecast in the tender evaluation for the corresponding period and costs. For the ATO and Group 5 agencies, the relative savings in cash outlays expected to be achieved through the outsourcing Agreements (compared to continuing internal service delivery) were significantly less than the reductions applied to agency budgets (representing 51 percent and 3 percent of the budget reductions respectively).[12] This analysis considered the estimated savings in relative agency cash outlays under the contracted pricing before the application of notional CN adjustments, and should be viewed in the light of the qualifying factors identified above.

Industry development

32. In each case, the successful tenderer has made contractual in-scope ID commitments as to the proportion of service charges that will relate to high Australian value added activity, and the minimum proportion of service charges that will be paid to small to medium enterprise (SME) subcontractors (ranging from 6 percent under the Group 5 Agreement to 26 percent for ATO). Each ESP has also committed to a series of out-of-scope ID initiatives, including commitments regarding minimum levels of strategic investment, exports and regional employment.

33. The Cluster 3, ATO and Group 5 Agreements require the relevant ESP to provide an annual report to the Department of Communications, Information Technology and the Arts (DoCITA) on its achievement against its ID commitments. The first annual report of the Cluster 3 ESP in June 1999 reported that all targets for both in-scope and out-of-scope commitments had been either met or exceeded, with significant over-achievement reported in strategic investment and employment. DoCITA has continued to improve its procedures and practices for ID monitoring, including audit requirements of ESPs' annual reports.

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[12] In the case of the ATO, $3.6m in expected cash outlays for contracted sales tax-related costs were not included in the calculation of savings for tender evaluation purposes. Those costs have been included by ANAO for the purposes of comparing relative cash savings expected to be achieved under the outsourcing Agreement with the cash budget reductions.

Agency implementation

34. The initial contract management effort required in respect of the Cluster 3, ATO and Group 5 Agreements has exceeded the expectations of many agencies, with the increased management effort and transaction costs occurring at both the operational and senior executive levels. Many of these latter costs resulted from the need for senior management to focus on the delivery of the relevant services to an extent not previously experienced in order to address initial service delivery problems. These transaction costs are not fully captured in the overall reported costs of managing the Agreements. Within the multi-agency groups, the transaction costs incurred by smaller agencies in relation to the value of services received were considerable in comparison to the larger agencies.

35. A stabilisation period can be expected following outsourcing, but it has taken longer than expected to obtain the anticipated level of cost and performance visibility and, in some areas, to achieve contracted levels of service. The experience of Cluster 3 and Group 5 highlighted that both agencies and tenderers underestimated the complexity involved in simultaneously transitioning to an outsourced provider the delivery of IT infrastructure services to a number of agencies. In each of the tenders reviewed, a number of factors contributed to difficulties in initial service delivery following handover to the ESP. These particularly related to aspects of the knowledge-transfer processes undertaken and included low levels of agency staff transferring to the ESP, and the effectiveness of aspects of the due diligence and transition processes.

36. The transfer of responsibility for the outsourced services to the ESP appears to have proceeded with the fewest initial problems in the case of the single agency ATO Agreement. However, the areas in which service delivery disruption did occur were areas of high end-user impact such as help desk services. In the multi-agency groups of Cluster 3 and Group 5, there has been considerably more disruption to service delivery, with significant shortfalls in the provision of contracted service levels during the first year of each Agreement. This impacted, to varying degrees, on productivity in the relevant agencies. The complexity of the changes made to the Cluster 3 infrastructure in the first year of the Agreement, and the level of agency and ESP resources devoted to implementing them in a limited timeframe, appear to have contributed to the significant service delivery difficulties Cluster agencies experienced at various times during this period. The disparate size, priorities and business requirements of Cluster agencies have also contributed to service difficulties. There have been subsequent improvements in the level of service delivered by the Cluster 3 ESP.

Service credits

37. The Cluster 3, ATO and Group 5 Agreements provide for the payment of service credits to the agencies by the respective ESP where contracted service levels are not met. Each Agreement also provides the relevant agencies with a discretion as to whether to impose service credits accrued as a result of the ESPs' contractual non-performance. All service credits accrued by the ATO ESP to June 2000 ($1.1 million) were imposed by the ATO, representing about 1.5 percent of service charges paid. Group 5 agencies had imposed all service credits accrued by the ESP between July and December 1999. Totalling some $960,000, these service credits were significant, representing an average of about 18 percent of relevant service charges.

38. The approach adopted to the application of service credits in Cluster 3 has differed from that taken by the ATO and Group 5. The Cluster 3 Management Committee (Cluster 3 MC) elected to provide the ESP with an initial three month grace period during which it would not be liable to pay service credits. The Cluster 3 MC subsequently agreed to a revised regime that significantly reduced the ESP's exposure to service credits in respect of its performance in 1998-99. The intent of the arrangement was to provide the ESP with incentive to achieve contracted service levels and its Year 2000 (Y2K) compliance obligations, while giving due consideration to 'extenuating circumstances' identified by the ESP. The ESP subsequently fulfilled its Y2K obligations within the required timeframe, but did not achieve minimum service levels specified under the revised service credit regime.

39. All service credits provided for under the revised regime were subsequently imposed by the Cluster, being $2.4 million in service credits for services delivered in 1998-99. This represented about 6 percent of invoiced service charges between October 1998 and June 1999. However, under that arrangement, at least $1.3 million in service credits representing resources contractually-available to the Commonwealth were not imposed in 1998-99, and a lower minimum level of service for business-critical services than that required under the original contract was agreed for a period of time. ANAO considers that, given the resource management obligations arising under section 44 of the *Financial Management and Accountability Act (1997)*, enhanced documentation of the value-for-money analysis undertaken by Cluster agencies as the basis for agreeing to the initial service credit moratorium and subsequent service credit arrangement, and of the Cluster's monitoring of achievement of that value-for-money, would have improved the transparency of decision-making on this matter. As noted above, there has been improvement in the level of service delivered by the ESP since that time.

Security and privacy

40. ANAO identified differing approaches between agencies in respect of recommended preparatory steps for the security aspects of outsourcing IT infrastructure. There was scope for improvement in the extent, and timing, of attention to these issues in the Cluster 3 and Group 5 tenders. As at August 2000, full security certification of the Cluster 3 network had not yet been obtained in line with the contractual requirements. A factor in the extensive delay appears to have been an inadequate appreciation at the time of executing the 1998 Agreement of the effort and resource commitment entailed by both parties in obtaining the level of sign-off being sought. The ATO and Group 5 Agreements set out a framework of security obligations on the ESP, and provide for the audit and inspection of compliance with those obligations, but do not include specific contractual obligations for the ESP to obtain external security certification of its systems. Neither Agreement identifies which party is responsible for the costs associated with obtaining external security certifications or assessments where agencies consider this appropriate.

41. The Privacy Commissioner's Guidelines in relation to outsourcing contracts provide that monitoring by agencies of ESPs' compliance with privacy requirements should be undertaken on a regular basis. Shortly after the ATO Agreement commenced in June 1999, the ATO Internal Audit Branch commenced audits of the ESP's compliance with its privacy requirements but had yet to complete this important task during the period of audit fieldwork. In commenting on the proposed audit report, the ATO advised ANAO in August 2000 that its Internal Audit Branch had completed its reports into *Privacy, Security and Access*, and that *'the actions to address the issues identified are being implemented.'* Group 5 and Cluster 3 were yet to develop a strategy for monitoring the respective ESPs' compliance with its privacy obligations.

Invoicing

42. The provision by ESPs of accurate and appropriately substantiated and detailed invoices has proven to be an area of difficulty under each of the Agreements reviewed, particularly in the initial phases of service delivery. The experiences of Cluster 3, ATO and Group 5 agencies highlighted that the ability of the ESP to provide the invoicing data required to support agencies in satisfying their statutory obligations and internal budgetary requirements is an area on which agencies involved in future IT outsourcing agreements will need to place particular focus.

Improvement opportunities

43. ANAO made 20 recommendations identifying opportunities for improvement in the management and ongoing implementation of the whole-of-Government IT Initiative. Specific areas for improvement include:

- on-going strategic oversight and evaluation of IT outsourcing by Commonwealth agencies;
- enhancing the transparency and accountability of tender processes and evaluation outcomes as they relate to tender planning and the presentation to the decision-maker of comprehensive information on recommended outcomes;
- the financial evaluation method adopted to reflect the agreed financial value to the Commonwealth from the proposed arrangements, including the appropriate treatment of end-of-period assets; and
- overall contract management, including the governance arrangements for the management of discretionary service credits; monitoring of ESP's performance and contractual obligations; management of security and privacy obligations; and the adequacy of invoicing arrangements.

Agency responses

44. Under section 19 of the *Auditor-General Act 1997*, the proposed audit report was issued to relevant Commonwealth agencies for comment in late July 2000. Other parties having a special interest in the report were also provided with the report or relevant extracts for comment. The Department of Employment, Workplace Relations and Small Business (DEWRSB) commented that it '*supports in-principle the recommendations of the audit report*'. The Department of Defence (Defence) response commented that '*the report is fully consistent with the experience of DSD's Information Security Branch in supporting IT outsourcing initiatives, in particular the Cluster 3 and ATO exercises*'.

45. The Department of Finance and Administration (DOFA) provided a formal whole-of-government response to the section 19 proposed report on 24 August 2000 which covered the following agencies and statutory authorities: DIMA, AEC, IP Australia, DOFA, OASITO, ATO, DISR, PM&C, DoCITA, ACCC and DoTRS.

46. The DOFA whole-of-government response commented that:

> [The Report] *provides only a limited view that does not reflect the overall quality and rigour of the tender processes and the implementation/transition efforts undertaken for each service agreement. In relation to contract management, the Report focuses heavily on process and documentation and, consequently, encourages an overly process-oriented and literal approach to contract management that may not produce the best service delivery and value for money outcomes for the Commonwealth. It also fails to provide a balanced assessment of the effectiveness of the various processes undertaken.*

47. In response to the DOFA response ANAO observes, as per paragraphs 4 and 8, that the focus of the audit was on the overall management of the IT Initiative by OASITO; the tendering process of the four tenders completed at the time the audit commenced; and on the management by the relevant agencies of the resulting Agreements. The quality of the processes used in pursuit of the IT Initiative's objectives impacts on the quality of the outcomes that can be achieved, as illustrated in this report. The development and management of complex legal relationships, such as those established under the IT Initiative which involves the projected expenditure of over $730 million in public monies for the first three contracts, requires a structured approach to ensure that the Commonwealth's legal, commercial and operational interests are effectively protected, the accountability requirements of the public sector are met and the expected outcomes are delivered.

48. The audit identified significant scope for improvements which would enhance, in future tenders, the effectiveness of the various processes examined by the audit, including in relation to overall management and evaluation of the IT Initiative, tender evaluation and management of the Agreements. As also noted in paragraph 4, it is too early to make any assessment of the overall impact of full implementation. The significant effort on the part of OASITO and participating agencies in the tendering processes and the limited timeframes involved were acknowledged specifically in paragraph 9.

49. DOFA's whole-of-government response agreed or agreed with qualification with 16 recommendations and disagreed with four recommendations. Defence and the Privacy Commissioner agreed with Recommendations 18 and 19 respectively.

Recommendations

Set out below are the ANAO's recommendations. ANAO considers that agencies should give priority to Recommendations, 1, 3, 5, 8, 12, 13, 14, 17 and 18.

Recommendation No.1
Para. 2.25

ANAO *recommends* consideration of the advantages to the Commonwealth of having a specific agency assigned responsibility for the conduct and coordination of market surveillance and analysis to support and inform strategic planning by agencies for the re-tendering of outsourcing Agreements following completion of the initial implementation of the IT Initiative.

Agree: DOFA whole-of-government response

Recommendation No.2
Para. 2.48

ANAO *recommends* that, as part of the management of Commonwealth IT outsourcing contracts, relevant agencies institute a framework to support the identification of opportunities to enhance the synergistic benefits available from the composition of agency groupings, either during the initial contract term, where cost-effective, or in the future re-tendering of the outsourcing agreements.

Agree: DOFA whole-of-government response

Recommendation No.3
Para. 2.66

ANAO *recommends* that:

a) OASITO and DOFA agree a timetable for the finalisation and implementation of an evaluation strategy for assessing whole-of-Government outcomes achieved under the IT Initiative;

b) relevant agencies develop an evaluation strategy for consistently assessing and reporting outcomes achieved under IT outsourcing arrangements from the perspective of agency groups and individual agencies; and

c) OASITO considers further enhancing its lessons learned processes through the development of mechanisms for the collection, distribution and maintenance of documented lessons learned material, together with appropriate request for tender and contractual material, arising from previous IT outsourcing tender processes to assist agencies undertaking subsequent processes.

Agree: DOFA whole-of-government response

Recommendation No.4
Para. 3.29

ANAO *recommends* that, where appropriate, OASITO improve its management of the Strategic Adviser consultancy for the remaining duration of the IT Initiative by defining key deliverables and milestones required to be delivered by the Strategic Adviser.

Agree with qualification: DOFA whole-of-government response

Recommendation No.5
Para. 4.9

ANAO *recommends* that, in future IT outsourcing tenders, relevant agencies ensure that a comprehensive brief confirming the contractual arrangements negotiated with the preferred tenderer, including updated analysis of cost savings, industry development commitments and satisfaction of evaluation criteria, is provided to the relevant Ministers in support of any recommendation to enter into the final contract.

Agree: DOFA whole-of-government response

Recommendation No.6
Para. 4.26

ANAO *recommends* that agencies ensure that consultancy agreements developed for the provision of probity auditing services in future IT outsourcing tenders stipulate:

(a) that a comprehensive probity plan is to be finalised <u>before</u> the commencement of the tender process;

(b) the nature of any sign-offs and reports to be provided by the probity auditor to the decision-maker; and

(c) that the scope of the probity auditor's services include provision of a formal sign-off to the decision-maker prior to the execution of the final contract.

Agree: DOFA whole-of-government response

Recommendation No.7
Para. 4.52

ANAO *recommends* that, when conducting financial evaluations involving uneven cash flows over time, relevant agencies account for the time value of money in net present value terms, consistently applied in the evaluation outcomes presented to the decision-maker.

Agree with qualification: DOFA whole-of-government response

Recommendation No.8
Para. 4.61

ANAO *recommends* that, for future IT outsourcing tenders, relevant agencies enhance transparency and accountability of decision making in the tender process by incorporating into the evaluation planning process consideration of the <u>means</u> by which tenderers will be ranked in terms of the best combination of value for money/cost savings and industry development criteria.

Disagree: DOFA whole-of-government response

Recommendation No.9
Para. 5.22

ANAO *recommends* that, in future IT outsourcing tenders, relevant agencies consider the release of a draft Request for Tender for industry comment to assist in the development of IT offerings that will maximise competitiveness and support the achievement of cost-effective outcomes.

Agree: DOFA whole-of-government response

Recommendation No.10
Para. 5.62

ANAO *recommends* that, in future IT outsourcing tenders, relevant agencies enhance the transparency and accountability of decision making by documenting explicit consideration of the extent to which tenderers comply with all evaluation criteria and preconditions identified in the Request for Tender.

Agree: DOFA whole-of-government response

Recommendation No.11
Para. 6.65

ANAO *recommends* that relevant agencies ensure that future IT outsourcing agreements complement the Government's whole-of-Government telecommunication policy by stipulating a requirement that:

a) relevant services be provided to agencies in accordance with whole-of-Government telecommunications arrangements, including that services must be procured under a whole-of-Government Head Agreement supported by appropriate reporting arrangements; and

b) all telecommunications services be procured in the name of the Commonwealth unless otherwise agreed in writing by the Office for Government Online.

Agree: DOFA whole-of-government response - Part (a)

Agree with qualification: DOFA whole-of-government response - Part (b)

Recommendation No.12
Para. 7.17

ANAO *recommends* that, in order for the evaluation to identify the true financial value to the Commonwealth of future IT outsourcing tenders, relevant agencies include, at a minimum, the estimated fair market value of agency residual assets that provide service potential beyond the evaluation period.

Disagree: DOFA whole-of-government response

Recommendation No.13
Para. 7.31

ANAO *recommends* that, in conducting future IT outsourcing tender evaluations, relevant agencies:

a) identify the risks and benefits relating to ownership of assets that will be borne by each party under the proposed leasing arrangements in order to properly identify the economic substance of the transaction; and

b) inform the decision-maker of the financial implications of the proposed operating or finance equipment lease arrangements prior to execution of the final contract.

Agree with qualification: DOFA whole-of-government response

Recommendation No.14
Para. 7.44

ANAO *recommends* that, for future IT outsourcing tenders, relevant agencies properly account in the financial evaluation for any residual end-of-term Commonwealth obligations arising from underwriting tenderers' asset risk associated with the outsourced services.

Disagree: DOFA whole-of-government response

Recommendation No.15 Para. 7.78

ANAO *recommends* that, to ensure competitive neutrality adjustments are consistent with the conditions on which tenderers' pricing is based, OASITO, in consultation with DOFA, review the methodology to be applied in future IT outsourcing tenders for the calculation of adjustments for the required rate of return on agency assets in situations where the Commonwealth underwrites the asset risk of tenderers.

Disagree: DOFA whole-of-government response

Recommendation No.16 Para. 8.78

ANAO *recommends* that, to assist in the verification of external service providers' reported performance, its compliance with contractual obligations, and as an aid to effective contract and resource management, relevant agencies consider the formulation and implementation of an independent review and evaluation program as soon as practicable in the term of an IT outsourcing arrangement.

Agree: DOFA whole-of-government response

Recommendation No.17 Para. 9.38

ANAO *recommends* that, in managing IT outsourcing agreements, relevant agencies develop procedures for the conduct and documentation of the processes followed in evaluating options for the use of contractually-available service credits to facilitate effective delivery by the external service provider of contracted services.

Agree with qualification: DOFA whole-of-government response

Recommendation No.18 Para. 9.70

ANAO *recommends* that, where appropriate in outsourcing IT infrastructure services, agencies develop, in consultation with Defence Signals Directorate, an integrated security architecture strategy that addresses operational security issues, identifies the necessary security safeguards and the required timetable for their implementation by the external service provider.

Agree: Defence and DOFA whole-of-government response

Recommendation No.19 Para. 9.80

ANAO *recommends* that, in implementing IT outsourcing arrangements, relevant agencies develop a specific strategy for monitoring external services providers' compliance with contractual privacy obligations.

Agree: Privacy Commission and DOFA whole-of-government response

Recommendation No.20 Para. 9.99

ANAO *recommends* that, in future IT outsourcing processes, relevant agencies:

a) ensure that the capacity of tenderers to provide the invoicing information and associated documentation required to support the approval of Commonwealth payments and agency budgetary purposes is appropriately assessed during the tender evaluation and transition phases;

b) specify in the outsourcing Agreement threshold invoice requirements that must be met before payment can be made; and

c) consider including in the transition milestones and deliverables required to be met in order for the external service provider (ESP) to receive full payment of transition fees, a requirement that the ESP demonstrate adequate capacity to provide invoicing that will satisfy the specified threshold requirements.

Agree: DOFA whole-of-government response—Parts (a) and (c)

Agree with qualification: DOFA whole-of-government response—Part (b)

Audit Findings and Conclusions

1. Introduction

This chapter discusses the objectives of the IT Initiative, progress achieved in its implementation, the roles and responsibilities of agencies and OASITO in the conduct of tender processes and the objectives, scope and focus of the audit.

Background

1.1 In the 1997-98 Budget, the Government announced the Whole-of-Government Information Technology Infrastructure Consolidation and Outsourcing Initiative (IT Initiative). The measure was directed at achieving long-term improvements in the structuring and sourcing of information technology (IT) services across agencies to facilitate greater integration in the delivery of programs and realise significant cost savings.

1.2 It was anticipated that a successful process of consolidation and outsourcing would lead to improved service delivery by integrating services to common client groups through consolidation of IT infrastructure; rationalisation and standardisation across agencies; economies of scale from integration of data centre processing requirements; cost-effective technical and user support across mainframe, mid-range and desktop/network platforms; improved management of IT services; and market leverage from larger volumes.[13] The Government also identified an opportunity to enhance the growth and competitiveness of the Australian information technology and telecommunications (IT&T) industry through the IT Initiative, particularly in regional Australia.

1.3 The focus of this performance audit is on the implementation by Commonwealth entities of the Government policy on IT consolidation and outsourcing. The extent to which a number of the Initiative's broader objectives are achieved will take some time to assess. At the commencement of this audit in March 1999, only four of the originally planned eleven tenders had been completed.

1.4 The 1997-98 Budget Papers stated that efficiencies would be obtained by consolidating the Commonwealth's IBM and IBM-compatible data centres, and outsourcing IT infrastructure services across all Budget-funded agencies subject to the outcome of competitive tendering processes.[14] IT&T services agencies were required to include in competitive

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[13] Budget Measures 1997-98, Budget Paper No.2, p 161.

[14] Agencies with Running Costs below $10 million in 1998-99 and agencies operating IT systems or services concerning national security were excluded from the scope of the measure.

tenders ('in-scope services') were all mainframe services, midrange systems, distributed and desktop operations, support services and data networks. The inclusion of voice telecommunications services[15] and/or applications development and support in tenders was to be optional for agencies.

1.5 A survey conducted by the Australian Bureau of Statistics of the resources devoted to IT&T goods and services by general government organisations identified that some 58 percent of IT&T-related expenditure within the Commonwealth in 1993-94 was directed at third-parties. Under the IT Initiative, this percentage will increase markedly, essentially through the provision of managed services to agencies, and the ownership and financing of assets by external service providers (ESP).

IT Initiative framework

1.6 The IT Initiative is based upon a framework in which the IT infrastructure and telecommunications requirements of agencies are gathered into a number of groups to be offered to the market. Tenderers must, at a minimum:

- tender to act as Prime Contractor or procurement agent for all services identified in the relevant Request For Tender (RFT); and
- propose an industry development plan (ID Plan) consisting of industry development (ID) commitments relating to the performance of the Services Agreement ('in-scope commitments') and commitments not relating to the performance of the services ('out-of-scope commitments').[16]

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15 In the 1996-97 Budget context, the Government required all Commonwealth departments and budget-dependent agencies to use mandated whole-of-government agreements for telecommunications carriage services. Under the Whole-of-Government Telecommunications Initiative, telecommunications carriers negotiate Head Agreements that provide a purchasing framework of telecommunications services in which the Commonwealth operates as a single purchaser of telecommunications services. This is intended to enable the pricing provided by a telecommunications carrier to one agency to be available to other agencies. The Office for Government Online (OGO) is responsible for whole-of-government telecommunications policy and the negotiation of whole-of-government Head Agreements with telecommunications suppliers. The telecommunications services provided under the IT Initiative are required to be supplied in accordance with the whole-of-government telecommunications policy. Mandatory reductions were made to agency forward estimates in the 1996-97 Budget in anticipation of savings expected to be obtained through whole-of-Government telecommunications arrangements.

16 Out-of-scope commitments are not required to be proposed by SMEs tendering as Prime Vendor, but where SMEs chose to propose such commitments, they were evaluated in the same manner as for other tenderers.

1.7 The overall strategy is to replace service delivery by agencies through component procurement with a service purchasing approach under which an ESP has end-to-end responsibility for delivering an integrated suite of services. This framework was expected to produce significant benefits, including financial savings in ESP charges (due to economies of scale and more vigorous price and performance competition); reduced tender costs to Government and industry; increased opportunities for rationalisation and standardisation between agencies; and efficiency in contract management.

1.8 This expectation was based upon the findings of the '*Evaluation of Consolidation and Outsourcing*' (the OGIT/DOF Evaluation)[17] jointly undertaken between August 1996 and March 1997 by the (then) Office for Government Information Technology (OGIT)[18] and the (then) Department of Finance (DOF).[19] The OGIT/DOF Evaluation compared the existing and projected 'business as usual' IT infrastructure costs of agencies with the costs estimated to arise under a whole-of-Government consolidation and outsourcing model based on the integration and aggregation of services between platforms and agencies.[20]

1.9 The estimated costs under the consolidation and outsourcing model were based on indicative prices provided by a number of ESPs in response to a Request for Information (RFI), together with the assumed impact of transition, retained and contract management costs. ESPs were provided with agency data except where it was designated as in-confidence. The report of the Evaluation, presented for consideration in the 1997-98 Budget context, identified significant financial and other benefits for agencies in outsourcing IT infrastructure under whole-of-Government arrangements.

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17 In the 1996-97 Budget, the Government agreed to a scoping exercise and initial market test to evaluate the costs, benefits and risks associated with the consolidation and outsourcing of Commonwealth IT infrastructure under a whole-of-government approach, including mainframe data centres, midrange and desktop/network computing platforms. The consolidation and outsourcing of IBM-compatible mainframe data centres was agreed to in-principle, subject to the outcome of the evaluation and a competitive process.

18 OGIT was responsible for implementation of the IT Initiative until November 1997, when responsibility was transferred to the (then) Office of Asset Sales, which became the Office of Asset Sales and IT Outsourcing (OASITO). In October 1998, OGIT became OGO.

19 The Department of Finance was reorganised in October 1997 to form the Department of Finance and Administration (DOFA).

20 Agency costs were measured across 63 agencies, estimated to represent 95 percent of in-scope IT infrastructure expenditure, using questionnaires and a standard costing methodology which incorporated full costs borne by agencies in accrual terms.

Budget savings

1.10 In anticipation of savings being realised from whole-of-Government IT consolidation and outsourcing, reductions were made to the forward estimates of Budget-funded agencies in the 1997-98 Budget. These reductions were $37.9 million in 1998-99, $87 million in 1999-00, and on-going annual reductions of $99.2 million from 2000-01.[21] Based on the conclusions of the OGIT/DOF Evaluation,[22] the reductions were described as estimates of the minimum net savings agencies could be expected to achieve through the consolidation and outsourcing of IT infrastructure. The OGIT/DOF Evaluation reported that, as the estimated savings were based upon the average of vendor pricing estimates from a non-competitive RFI process and other assumptions considered conservative, it could be expected that they would be considerably improved upon in any well run and open competitive tendering process.

1.11 In the implementation of the IT Initiative, if specific tender processes result in savings in excess of the Budget reductions, those savings are retained by agencies. If the tender processes result in lower savings, agencies must fund the difference internally. In 1997, the Government estimated that the IT Initiative would result in savings of approximately $1 billion over seven years.[23]

Agency roles and responsibilities under the IT Initiative

1.12 The 1997-98 Budget Paper No.2 stated that, whilst agencies were not required to consolidate or outsource IT infrastructure in the absence of a sound business case, they were expected to:

- apply a competitive tendering process to those services and achieve levels of efficiency and performance equivalent to those indicated in the OGIT/DOF Evaluation; and
- achieve savings.[24]

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21 This excluded savings from the Defence portfolio as a decision had not been made as to whether those savings would be returned to the Budget. Estimates Memorandum 1997/24 advised agencies that savings were being recovered over a staggered time frame to allow for completion of competitive tendering processes.

22 The OGIT/DOF evaluation concluded that, when fully implemented, consolidation and outsourcing could be expected to achieve aggregate net annual savings for agencies overall of at least 22 percent for mainframe data centres and 15 percent for midrange and desktop/network environments. This was based on the average pricing provided by vendors in response to the RFI. For agencies with mainframe environments, apart from the (then) Department of Social Security (DSS) and Health Insurance Commission (HIC), the savings were based on the average indicative prices obtained from the vendors in respect of those agencies. For DSS and the HIC, savings were based on the average percentage savings projected for all other agencies in the evaluation.

23 Media Release, Minister for Finance and Administration, 67/97, 7 November 1997.

24 Budget Measures 1997-98, Budget Paper No.2, p 161.

1.13 Responsibility for developing the framework for implementation of the IT Initiative, and for the overall management and coordination of tender processes, rested with OGIT until November 1997. Responsibility for the IT Initiative was then transferred to the Office of Asset Sales, which subsequently became the Office of Asset Sales and IT Outsourcing (OASITO).[25]

1.14 In December 1998, OASITO advised the Minister for Finance and Administration of a number of problems that had emerged in the implementation of the IT Initiative. OASITO advised of a need for greater clarity as to the underlying intent of the Initiative, as well as the respective roles to be played by OASITO and the agencies involved in each tender. On 22 December 1998, the Prime Minister advised all Portfolio Ministers that *'as a general Government policy, outsourcing of IT infrastructure services should proceed unless there is a compelling business case* <u>*on a whole-of-Government basis*</u> *for not doing so'* (emphasis added).[26]

1.15 In January 1999, the Minister for Finance and Administration issued revised guidance regarding the respective roles of OASITO and agencies in tender processes. These were broadly consistent with existing arrangements, but the overall coordination and management role of OASITO was clarified and strengthened in some key areas, including the conduct of the financial evaluation (see Figure 1.1).

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25 The management framework for the IT Initiative encompasses: identification of appropriate agency groupings; development and implementation of a strategy for the roll-out of tenders; development of a tendering and contracting 'template' for use (with appropriate adaptation) in each tender; coordination and overall management of each tender process; and development of outsourcing documentation and guidance for use by small agencies (agencies with 300 or fewer desktops) not included in the major group tenders.

26 Annual Report, Office of Asset Sales and Information Technology Outsourcing, 1998-99, p 31.

Figure 1.1

Principal agency roles and responsibilities in implementing the IT Initiative

OASITO	*Agencies*
• Strategic planning, including formation of agency groups and sequencing of tenders. • Manage tender processes. • Monitor tender document quality and assist agencies to formulate requirements. • Develop a set of financial models; supervise the population of agency baselines; in consultation with agencies, adjust tendered prices, baselines or business case as required. • Joint responsibility with the DoCITA for implementation of the ID framework. • Advise the Minister on significant proposed acquisitions, leasing programs or contracts. • General guidance and assistance to agencies participating in Small Agency Program. • Liaise with agencies after contract signature.	• Define service requirements within and subject to the required scope. • develop a cost model under OASITO supervision using proforma methodology. • Prepare materials for tenderer due diligence. • Formulate and implement strategies to address human resources transition and related issues; prepare the agency for management of the contract. • Evaluate IT services offerings & prepare reports; participate in negotiations; and determine whether negotiated outcomes meet agency service requirements. • Plan and manage transition of responsibility. • Contract management.

Source: Roles and Responsibilities for Agencies and OASITO in the IT Outsourcing Initiative, January 1999

Initiative implementation

1.16 As at June 2000, six of the twelve[27] major tenders now planned under the IT Initiative had been completed, with five resulting in executed Agreements involving the provision of about $1.2 billion in IT&T services over five years (see Figure 1.2). Full services had commenced under three of those Agreements. These were for the provision of IT&T services to Cluster 3, the first of the agency groupings under the Initiative, the Australian Taxation Office (ATO)[28] and Group 5, the first of the agency groups with no mainframe requirements (Figure 1.3 describes the member agencies of Cluster 3 and Group 5). These are the tenders considered in this audit, together with the Department of Employment, Education, Training and Youth Affairs (DEETYA) and Employment National (EN) tender (DEETYA/EN)[29] which was discontinued on 11 June 1998.

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27 Refer footnote 2.

28 The scope of services provided to ATO includes mainframe (900 millions of instructions per second (MIPS)), midrange, desktop network (18,000 personal computers (PC)), data and voice telecommunications (20,000 voice services) and bulk document printing and dispatch services.

29 DEETYA was reorganised in October 1998 into the Department of Education, Training and Youth Affairs (DETYA). The employment function was transferred to the Department of Workplace Relations and Small Business, which became the Department of Employment, Workplace Relations and Small Business (DEWRSB). DEWRSB and DETYA are to participate in later group tendering processes.

Figure 1.2

Major tenders completed under IT Initiative as at June 2000

Group	*Contract signed*	*Term*	*Value*	*ESP*
Tenders considered in audit:				
Cluster 3	31 March 1998	IT -5 yrs Voice—3 yrs Data—2 yrs	$157m	CSC Australia Pty Limited
DEETYA/EN	Discontinued 11 June 1998			
ATO	31 March 1999	IT—5 yrs Carriage—2 yrs	$487m	EDS (Australia) Pty Ltd
Group 5	14 April 1999	5 yrs	$88m	Advantra Pty Limited
Other tenders completed to June 2000:				
Health Group[30]	7 December 1999	5 yrs	$350m	IBM Global Services Australia
Group 8[31]	9 March 2000	5 yrs	$130m	IPEX ITG

Source: ANAO analysis of Service Agreements and OASITO records

30 Comprises the Department of Health and Aged Care, Health Insurance Commission and some IT requirements of Medibank Private Limited. Scope of services includes mainframe (1,300 MIPS); midrange; desktop network (8,000 PC); data telecommunications; and bulk document, card production and dispatch services.

31 Comprises Civil Aviation Safety Authority; Australian Communications Authority; Environment Australia; Agriculture, Fisheries and Forestry Australia; Public Service and Merit Protection Commission; Aboriginal and Torres Strait Islander Commission; and Australian Broadcasting Authority. Scope of services includes midrange and research information systems; desktop network (7,500 PC); and voice telecommunications (11,000 voice services).

Figure 1.3

Cluster 3 and Group 5 member agencies

Cluster 3[32]	• Department of Immigration and Multicultural Affairs (DIMA) • Australian Electoral Commission (AEC) • IP Australia[33] • Australian Surveying and Land Information Group (AUSLIG) • Australian Government Analytical Laboratories (AGAL) • Ionospheric Prediction Service • Department of Finance and Administration (DOFA) for Electoral Office Systems (EOS) • former DOFA bureau customers, including the National Crime Authority (NCA)[34]
Group 5[35]	• Department of Industry, Science and Resources (DISR) • Department of Communications, Information Technology and the Arts (DoCITA) • Department of Transport and Regional Services (DoTRS) • Department of the Prime Minister and Cabinet (PM&C) • Australian Competition and Consumer Commission (ACCC)

Source: Cluster 3 and Group 5 IT Services Evaluation Reports

1.17 A Request for Proposal for Group 1, comprising Centrelink and the Department of Family and Community Services, was released on 28 April 1999. The RFT was released to four pre-qualified tenderers on 15 December 1999, with the tender closing on 13 April 2000. A further four group tenders were scheduled to be released during 2000, with the Department of Defence (Defence) tender to follow shortly thereafter. OASITO advised ANAO that the timing of the remaining tenders would be determined following a review of the RFT timetable, having regard to agency program requirements and the need to ensure an orderly release of business into the market.

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32 The scope of services provided to Cluster 3 includes mainframe (250 MIPS), midrange, desktop network (5200 PC) and data and voice telecommunications (approximately 10,000 voice services).

33 As IP Australia (formerly the Australian Industrial Property Organisation) is not a budget-funded agency its involvement in the IT Initiative is voluntary. IP Australia decided to tender its mainframe services only.

34 The former Department of Administrative Services (DAS) operated a bureau service providing IT&T services to a range of agencies. Following the reorganisation of DAS and the Department of Finance in 1997, responsibility for the service was transferred to DOFA. DOFA advised its bureau customers that it did not intend to continue the service beyond 30 June 1998. The services provided to those customers, including NCA, were included in the Cluster 3 tender.

35 The scope of services provided to Group 5 includes midrange, desktop network (4000 PC), data and voice telecommunications (3,400 voice services) and applications development and maintenance (for two agencies).

Objectives of tenders considered in ANAO audit

1.18 This audit considered the first four tenders conducted under the IT Initiative, Cluster 3, DEETYA/EN, ATO and Group 5. The total value of the three contracts let is $732 million, comprising $157 million[36] for Cluster 3, $487 million[37] for ATO and $88 million[38] for Group 5. All four tenders considered by the audit were either completed, or already in tender evaluation, at the time of the Prime Minister's December 1998 letter.

1.19 In each case, the RFT identified the primary objectives of the tender as cost savings and ID. The overall objectives of the whole-of-Government strategy of consolidation and outsourcing were described as:

a) effective IT&T support of agency business needs and service delivery requirements;

b) substantial economies of scale resulting in improved efficiency, cost effectiveness and significant savings to the budget and to agencies;

c) improved effectiveness by moving to more standardised operating environments;

d) more efficient use of processing capacity;

e) improved service levels at lower costs;

f) leveraging access to private sector technology and know how;

g) improved technology solutions; and

h) improved potential for staff career development in an environment where IT&T is the core business.

1.20 Each RFT identified that the ID objectives the Government desires to achieve through the IT Initiative are to support growth in the Australian IT&T industries; promote the international competitiveness of the Australian IT&T industries; and support employment growth and development in Regional Australia.[39]

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36 In 1998-99 prices.

37 In 1999-2000 prices.

38 In 1999-2000 prices.

39 The ID priorities identified for in-scope activities were for the use of products and services with a high value-added Australian component, maximising opportunities for Small to Medium Enterprises (SME) to participate and the supply of innovative Australian products in the performance of the Services Agreement. The ID priorities for out-of-scope activities were for proposals that contributed to the growth and globalisation of the Australian IT&T industries, particularly growth and development of SMEs; were supported by commercially sensible business plans aligned with corporate strategies and plans; did not increase overall price of the services.

Audit approach

1.21 The objectives of the audit were to examine the administrative and financial effectiveness of the implementation of the IT Initiative, with the focus being on the first four tenders conducted. Accordingly, the audit assessed:

- the effectiveness of the overall planning and implementation of the IT Initiative, taking into account the tendering, contracting and monitoring processes undertaken in respect of Cluster 3, DEETYA/EN, ATO and Group 5;
- the extent to which those latter processes have contributed to the achievement of the objectives of the IT Initiative; and
- the extent to which the Commonwealth's interests have been adequately protected within this context.

1.22 The focus of this performance audit is on the implementation by Commonwealth entities of the Government's policy on IT consolidation and outsourcing. The extent to which a number of the Initiative's broader objectives are achieved will take some time to assess. At the commencement of this audit in March 1999, only four of the originally planned eleven tenders had been completed. Nevertheless, there are some important lessons to be learnt from experience to date, even though it is still too early to make any assessments of the overall impact of full implementation. The emphasis of the audit was on the overall management of the implementation of the IT Initiative by the Office of Asset Sales and IT Outsourcing (OASITO); the tendering process of the first four major tenders completed—Cluster 3, DEETYA/EN, ATO and Group 5 (including the application of the evaluation criteria set out in the relevant Requests for Tender (RFT) and the assessment of tenderers against the particular Government objectives as set out in the RFT); and on the management by the relevant agencies of the resulting Agreements.

1.23 The approach taken in the audit was to review data relating to the overall IT Initiative and specific tender processes held by OASITO and its advisers and by relevant agencies. The audit considered the steps taken in the management of the Initiative, the evaluation of tenders and in the contract terms negotiated to secure, as far as possible, the stated objectives. In the case of Cluster 3, the audit considered the management of the contract since its commencement in July 1998. In the case of the ATO and Group 5 Agreements, the audit considered the initial transition phase and the first six months of operation to December 1999.

1.24 The audit scope did not include a review of the findings of the 1997 OGIT/DOF Evaluation (on which the IT Initiative and associated reductions to future agency budgets were based), or the agency costing and baseline data prepared for each tender. The ability to conduct such an audit was limited by the passage of time and altered circumstances in the relevant agencies since the data was originally constructed, and by the resources available. Where, in the course of the audit, ANAO became aware of particular issues relating to those elements that were relevant to the efficiency and effectiveness of either the tender processes reviewed or the overall management of the Initiative, those issues were considered by ANAO.

1.25 ANAO's fieldwork was undertaken between March 1999 and December 1999. Six issues papers were provided to agencies for comment in December 1999, a discussion paper in May 2000 and the proposed report in July 2000. ANAO engaged the Australian Government Solicitor (AGS) to provide legal advice on a number of matters. The ANAO also engaged the Boston Consulting Group to provide strategic advice on commercial practice in IT outsourcing. The audit was conducted in accordance with ANAO Auditing Standards at a cost to the ANAO of $535,000.

2. Strategic Planning

This chapter discusses the strategic planning for implementation of the IT Initiative, the progress achieved, and opportunities for enhancing the ongoing strategic oversight of IT outsourcing by Commonwealth agencies.

Background

2.1 IT services are crucial to the successful delivery of a myriad of Commonwealth services and programs including the payment of income support benefits, border control processing and collection of revenue. The UK Cabinet Office recently reported that it had seen a variety of IT procurement approaches used across Government to satisfy a diversity of requirements, including joint ventures, framework contracts, private financing initiatives and strategic outsourcing.[40] Public and private sector organisations in Australia have increasingly outsourced non-core business activities as a means of improving efficiency. The outsourcing of IT services can provide a range of benefits that may include cost savings, accessing new technical solutions, enhanced flexibility of resources and access to specialist skills.

2.2 The process of outsourcing key business enablers for Commonwealth agencies, such as IT services, needs to be well-planned and prudently managed. This requires informed analysis of the basis on which outsourcing is undertaken; clear understanding of the business implications arising from outsourcing; well managed evaluation and selection processes; productive contractual relationships; and the maintenance of effective long-term control through appropriate exit strategies.

2.3 The Boston Consulting Group has identified a management framework that can assist in identifying whether particular activities should be outsourced, or retained and developed internally (see Figure 2.1). Management's decision is informed by the relative performance of in-house supplied services and the level of dependency on IT services for the achievement of core business outcomes. If performance of an in-house IT function is unsatisfactory, and the agency has a low dependency on such services, they are candidates for immediate outsourcing (see lower left quadrant of Figure 2.1). Where dependency is low, but

40 Review of Major Government IT Projects, *Successful IT: Modernising Government in Action*, UK Cabinet Office, May 2000.

performance high, or vice versa, outsourcing is an option that should be considered in an organisation's particular circumstances. Commonwealth policy is that budget-funded agencies should outsource IT infrastructure services unless there is a compelling business case on a whole-of-Government basis for not doing so.

Figure 2.1

Strategic IT business management decision framework

High	***Immediate Action Not Required***	***Leverage For Growth***
Relative Performance Of Activity	• May leverage or outsource in time • Outsource if distraction • Leverage if high potential	• Develop as core business grows • Grow independent of core business
	Outsource/Sell	***Improve (Then Leverage)***
Low	• Immediately actionable • Industrial relations risk may force down 'improve' path	• Threaten to outsource but prefer to retain • Must retain so focus on internal improvement (eg re-engineer)
	Low **Dependence On Activity**	**High**

Source: The Boston Consulting Group, *The Outsourcing Process—A Strategic Framework and Manual*, 1998

Initiative rollout planning

2.4 The IT Initiative involves the tendering of an unprecedented volume of business to industry in a limited period of time. In such an undertaking, sound and realistic strategic planning will contribute to the conduct of efficient and effective tendering processes for both agencies and prospective tenderers. The capacity of industry and agencies to absorb the volume of tendering activity proposed is an important consideration in such planning, particularly to ensure a competitive environment for each tender. Initial planning for the IT Initiative drew on advice received from industry participants in the OGIT/DOF evaluation phase regarding intended participation in the IT Initiative. However, industry interest in participating in tenders under the IT Initiative, and its capacity to absorb the volume of tendering activity being undertaken, has varied from that originally expected. This has been a significant factor in the need to revise and extend the implementation schedule for the Initiative in order to improve the competitive environment for each tender.

2.5 The original timetable required implementation to be completed by June 1999, but only four of the eleven major tenders originally planned were completed by that date. In proposing the IT Initiative in the context of the 1997-98 Budget, OGIT indicated that, given the importance of agency flexibility in relation to the structure of clusters, it had not considered it appropriate to develop a rigid schedule for implementation of competitive tendering processes. The first RFT, Cluster 3, was released on 4 November 1997, seven months after the Initiative was announced. A second group of agencies, Group 5, formed in June 1997, but progress on that and other tenders was delayed by the need to focus the resources of OGIT and its advisers on the Cluster 3 tender.[41] There was also a significant delay in the engagement by OGIT of the panel of expert advisers needed to assist agencies in tender preparation activities.

2.6 The need for a more coherent and comprehensive rollout plan was recognised by OGIT in November 1997, when a number of strategic issues and external pressures were identified as impacting adversely on the Initiative's successful implementation. In particular, OGIT identified the need for a more sophisticated commercial and strategic approach to managing the simultaneous market testing of a number of clusters within a relatively short timeframe.[42] It was noted that timetable pressures were becoming critical as savings would be removed from agency budgets from the end of 1998.

41 The second RFT, DEETYA/EN, was released in February 1998, some ten months after the Initiative was announced. The Group 5 RFT was released in June 1998, a year after the Group first formed.

42 Internal OGIT documentation noted that the approach adopted to that time had been modelled on the Department of Veterans Affairs and Australian Customs Service outsourcing projects.

2.7 The first comprehensive implementation plan for the Initiative, known as the IT Initiative Rollout Strategy, developed by OASITO[43] in consultation with the Strategic Adviser[44] and Industry Development Advisers engaged to assist in the implementation of the Initiative, was endorsed in December 1997 by the Minister for Finance and Administration.[45] It involved the release of at least eleven major agency groups[46] over eighteen months to the first quarter of 1999.[47]

2.8 In recommending the rollout plan, OASITO noted that it was a dynamic strategy, particularly in regard to the timing of the release of tenders, and should be flexible enough to accommodate appropriate changes required through new or different information concerning agencies' technical and business requirements or machinery of Government or policy changes. The Strategic Adviser noted that the schedule represented a large volume of business for industry to absorb in a relatively short period of time, particularly having regard to the substantial volume of IT outsourcing activity in the wider market.[48]

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[43] The strategy document noted that agencies had been consulted to ascertain information concerning their general technical and business requirements, timing and readiness for releasing an RFT, and that industry associations were consulted for their views and suggestions on the proposed grouping strategy.

[44] A United States-based firm, Shaw Pittman Potts and Trowbridge, engaged since mid-1996 to provide strategic advice and technical assistance to the IT Initiative.

[45] The Strategic Adviser and OASITO drew upon initial planning conducted as part of the OGIT/DOF Evaluation, and further planning by OGIT following announcement of the Initiative in April 1997, including the grouping of agencies.

[46] At that time, seven agencies or portfolios of significance, representing 10 percent of the total IT expenditure in-scope for the Initiative, had been identified as candidates for inclusion in the major agency groups but, for various reasons, had not been allocated to groups.

[47] A separate 'Small Agency Strategy' was also developed, under which guidance for the conduct of individual tender processes was issued to agencies with fewer than 300 desktops.

[48] The Strategic Adviser commented that '*there is no doubt that industry resources will be stretched and it is therefore likely that vendors will bid selectively*'. However, the Strategic Adviser considered that the proposed schedule provided vendors with a reasonable basis to manage their resources and maximise the number of tenders for which they bid.

2.9 The rollout plan was constructed within the constraints of the endorsed June 1999 completion date for the IT Initiative. That timeframe had been based upon initial planning by OGIT, which incorporated an assumption that the necessary competitive tendering processes could be completed by 31 December 1998 for mainframe agencies, and 30 June 1999 for other agencies. This was also endorsed as the timeframe for the application of reductions to agency budgets. At the time of forming that assumption, OGIT had yet to identify the appropriate number and composition of clusters, particularly for agencies with no mainframe requirement. OGIT had consulted with a number of these smaller agencies to test the feasibility of alternative clustering arrangements, and indications of industry participation in tenders had been obtained through responses to the RFI. OASITO advised ANAO that:

> *Input was sought from industry on a number of occasions, with substantial material being put forward in response to the RFI conducted by OGIT. While we acknowledge, in hindsight, the initial timetable was optimistic, it was based on a presumption of agency cooperation and claims made by the industry that it could cope with the workload as long as it was not all put out at once.*

2.10 It became apparent during 1998 that the rollout plan was not effectively supporting implementation of the IT Initiative, having regard to the limited capacity of agencies and industry to absorb the volume of tendering activity required, and the need to ensure adequate levels of competitive pressure for each tender. It had also become apparent that the June 1999 timeframe could not be achieved in logistical terms.

2.11 In April 1998, OASITO noted that its experience had clearly demonstrated that the potential market place had limited resources and targeted plans to participate in Commonwealth IT outsourcing. It was acknowledged that it was necessary to re-examine the rollout plan in that context *'rather than to assume, as we may have in the past, that there will be guaranteed competitive market interest for all groupings.'* OASITO recommended that multiple concurrent transactions be avoided where possible in order to maintain competitive pressure and optimise market opportunities for small to medium enterprises (SME).[49] This represented

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[49] For the purposes of the IT Initiative, an SME is defined as: 'Small'—a company incorporated in Australia or New Zealand which together with its Related Bodies Corporate and parent entities has an aggregate annual revenue of less than A$20 million; or has annual revenue of less than A$20 million and together with its Related Bodies Corporate and parent entities an aggregate annual revenue of more than A$20 million and its ultimate holding company is a venture capital organisation. For 'Medium' companies, the revenue thresholds are A$250 million.

a different approach to that envisaged in the initial rollout plan, which had called for the release of four mainframe and five non-mainframe tenders over twelve months in 1998.[50]

2.12 In October 1998, the Strategic Adviser advised OASITO that the existing timetable for the IT Initiative would outstrip industry's capacity to bid competitively and needed to be adjusted. Based on an assessment of the IT Industry, the Strategic Adviser had concluded that industry has very limited capacity to absorb a series of large-scale, complex and high risk outsourcing tenders, with even the established multinational vendors stretched thin in terms of their capacity to bid and safely transition infrastructure and staff out of the public sector. The Strategic Adviser also expressed the view that perceptions of agency resistance to outsourcing were having a significant impact on the level of competitive interest in the IT Initiative.

2.13 A revised implementation schedule extending the completion date for the Initiative to December 2000 was endorsed in December 1998.[51] As at June 2000, at least four of the remaining tender processes were unlikely to be completed by December 2000.[52] In June 2000, DOFA advised ANAO that, while acknowledging revision to the initial planning undertaken had been necessary:

> *DOFA would suggest that this is the largest outsourcing initiative of its kind ever undertaken by the Commonwealth. The initial timetable was based on expert advice and the best information available at the time, including indications from Industry with regard to their capability to undertake these contracts. As experience was gained, and new information obtained, revisions to the timetable were necessary. This type of real-time revision happens with major projects and initiatives as part of a continuous improvement process.*

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50 OASITO advised ANAO that one of the significant factors limiting market capacity was the decision not to participate by a number of large suppliers that had earlier indicated interest in the IT outsourcing program.

51 The revised schedule took account of the effects of changes to departmental arrangements in October 1998.

52 These were Group 11, Group 9, Group 10 and Defence, for which RFTs were yet to be released as at June 2000. The future progress of Group 6, involving Department of Foreign Affairs and Trade was also unclear.

Implications of extended rollout timeframe

2.14 The reductions to agency budgets identified in the 1997-98 Budget came into effect in January 1999 for mainframe agencies, and July 1999 for non-mainframe agencies. This was intended to coincide with the original timeframe for implementation of the IT Initiative. The extended timeframe needed to complete the competitive tendering processes under the Initiative has resulted in a mis-match between the timing of those processes and the reduction of agency budgets in anticipation of savings being generated through outsourcing. For some agencies, budget reductions will have been in effect for up to two years before the competitive tendering process is complete.

2.15 In October 1996, agencies were advised that pending consideration of the outcome of the OGIT/DOF evaluation process, upgrades or replacement of IT&T facilities were to be minimised and confined to essential changes to sustain approved service levels.[52] The objective of these arrangements was to protect the benefits able to be obtained through the implementation of options for consolidation and standardisation across agencies.[53] Agencies were further advised in July 1997 that, in order to protect the potential benefits from the IT Initiative, the arrangements remained in place pending completion of the competitive tendering processes.[54]

2.16 In that environment, delays in the implementation of the Initiative had the potential to inhibit the capacity of agencies to institute strategic IT developments in support of business requirements. However, OASITO advised ANAO that the interim framework established for significant IT acquisitions had been applied on a flexible and pragmatic basis as the IT Initiative progressed, so as to allow agencies to pursue strategic directions and replace/upgrade existing infrastructure on a 'business-as-usual' basis, while seeking to ensure that short term sourcing decisions did not create 'poison pills' for subsequent outsourcing transactions.

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53 Estimates Memorandum 1996/25, October 1996.

54 Agencies were advised that, unless there were overwhelming business requirements to be satisfied, it may be difficult to justify further substantial investments in an incumbent technology or systems solution that was likely to add to the cost of transition to more integrated, cross-agency platforms and/or more standardised IT architecture under a whole-of-Government approach, add to the cost of delivering approved service levels across the outsourcing market or risk a disproportionate loss in IT capital investment in the event of outsourcing.

55 Estimates Memorandum 1997/31, July 1997.

2.17 OASITO identified a number of instances in which agencies have implemented major strategic IT developments as well as 'business as usual' upgrades and replacements of existing technology during the outsourcing process within the terms of the interim major acquisition framework. Examples have included major IT upgrades and new systems development undertaken by the ATO, Centrelink and the Health Insurance Commission, and the refresh of desktop networks by two Group 5 agencies.

2.18 At the same time, another member of Group 5, DoTRS, reported that it had experienced a delay in implementing strategic IT development. The successful tenderer took over delivery of IT services to the Group in July 1999, nearly three years after the initial direction restricting IT investment, and two years after the Group first formed. In September 1999, DoTRS noted that it had experienced a three year hiatus in IT strategic development which was described as having left the Department with an antiquated network operating system and associated costs to efficiency. OASITO advised ANAO that DoTRS' decision to delay technology upgrades was inconsistent with the approval of similar upgrades as a matter of course during the IT Initiative.

2.19 In some cases, the delay in implementing the IT Initiative has had staffing implications, with agencies reporting difficulties in recruiting and retaining suitable staff due to the extended uncertainty. It is noted, however, that a number of agencies were already experiencing such difficulties due to the competitive IT employment market.

2.20 Experience gained in implementing the IT Initiative highlighted the importance of on-going market surveillance to support the strategic planning of IT tendering activities. The need for robust analysis of environmental factors affecting the availability of a competitive market will continue beyond the initial implementation of the Initiative. By that time there will be a significant number of IT outsourcing agreements in operation across the Commonwealth that will need to undergo periodic re-tendering processes. A key issue for the Commonwealth will be the ability to promote effective competition in those processes.

2.21 Comprehensive and coordinated surveillance of the IT outsourcing market, and of the nature and timing of agencies' intended approaches to the market, would assist in enhancing the outcomes achieved from future re-tendering processes. Co-ordination of the timing of re-tendering would also be useful in enhancing opportunities to cost-effectively rationalise or revise agency groupings to meet changing agency and Government needs. It is currently unclear where responsibility for an on-going monitoring and coordination role of this nature is intended to lie.

2.22 **Finding:** Implementation of the IT Initiative has involved significant effort on the part of OASITO and participating agencies. The IT Initiative involves the tendering of an unprecedented volume of business to industry in a limited period of time. Although initial planning drew on advice received from industry participants, industry interest in participating in tenders under the IT Initiative, and its capacity to absorb the volume of tendering activity being undertaken, has varied from that originally expected. This has been a significant factor in the need to revise and extend the implementation schedule for the Initiative in order to improve the competitive environment for each tender. The original timetable required implementation to be completed by June 1999, but only four of the eleven major tenders originally planned were completed by that date. A revised implementation schedule extending the completion date for the IT Initiative from June 1999 to December 2000 was announced in December 1998. As at June 2000, at least four of the remaining tender processes were unlikely to be completed by December 2000.

2.23 The extended timeframe needed to complete the competitive tendering processes under the Initiative has resulted in a mis-match between the timing of those processes and the reductions to agency budgets applied in anticipation of savings being generated through outsourcing. For some agencies, budget reductions will have been effect for up to two years before the competitive tendering process is complete.

2.24 Experience in implementing the IT Initiative highlighted the importance of on-going market surveillance to support the strategic planning of IT tendering activities. The need for robust analysis of environmental factors affecting the availability of a competitive market will continue beyond the initial implementation of the IT Initiative, by which time there will be a significant number of IT outsourcing agreements in operation across the Commonwealth.

Recommendation No. 1

2.25 ANAO *recommends* consideration of the advantages to the Commonwealth of having a specific agency assigned responsibility for the conduct and coordination of market surveillance and analysis to support and inform strategic planning by agencies for the re-tendering of outsourcing Agreements following completion of the initial implementation of the IT Initiative.

2.26 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response:*** **Agree**.

Agency groupings

2.27 The approach adopted under the IT Initiative is to group agencies together for the competitive tendering of IT infrastructure. The concept of consolidating Commonwealth IT infrastructure across agencies to achieve economies of scale was initially considered in respect to mainframe data centres in the 1995 *Clients First* report.[56] That report found that, although a number of Commonwealth agencies were already at, or close to, an economic size in terms of data centres, there were a number of smaller sites which could be consolidated. The report recommended that the consolidation of infrastructure be considered by aggregating like agencies on the basis of business type.

2.28 The grouping concept was expanded in the 1997 OGIT/DOF Evaluation, with the incorporation of midrange and desktop/network computing platforms. The Evaluation reported that responses from vendors had indicated that the outsourcing of IT services in multi-agency clusters would result in significant financial savings compared with separate outsourcing activities by individual agencies. The report of the Evaluation also noted that it had drawn general conclusions on the future benefits of a whole-of-Government approach, but acknowledged the need for additional systematic and rigorous evaluation in support of specific competitive tendering processes.

2.29 The formation of agency groups for the purposes of outsourcing IT services has not previously been undertaken on the scale involved in the IT Initiative. Identifying and forming optimal groups is a complex task which is further complicated by agency timing and business preferences, as well as vendor preferences for certain types of business and opportunities for growth. The primary considerations applied by the Strategic Adviser and OGIT, and then OASITO, in developing the eleven agency groups were agency preferences, synergies between agencies, economies of scale provided by particular groupings, and the manageability of agency groups.[57]

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56 Clients First—*The challenge for Government information technology*, Report of Minister for Finance's Information Technology Review Group, 1 March 1995. The report noted that the submission to the Review Group from IBM Limited had estimated savings from increased outsourcing of government information technology services to be in the range of $1 billion over the subsequent five or six years, based on a net benefit of 20 percent.

57 OASITO advised ANAO that, while changes have been made to the groupings of agencies, the OGIT/DOF Evaluation and earlier work conducted by OGIT had established the groupings prior to OASITO assuming responsibility for the IT Initiative in November 1997.

2.30 The documentation available to ANAO indicated that the analysis supporting these considerations consisted of desk reviews and discussions with agencies on potential groupings, having consideration for factors such as volumes, existing IT infrastructure, general area of business, geographic location and the timing of future objectives and plans. OASITO also consulted with industry on a number of occasions, particularly in regard to the timing of tender processes. There have been a number of changes to those groups, many relating to changes in agency and government requirements.

2.31 In recommending the December 1997 Rollout Strategy, the Strategic Adviser informed OASITO that synergies were generally more important in outsourcing midrange and desktop/network environments. This was because outsourcing vendors may be able to achieve savings in the mainframe environment, despite the absence of obvious synergies, by migrating operations to a shared data centre that services multiple public and private sector customers. The OGIT/DOF Evaluation noted that the benefits of clustering were most apparent in the smaller sites. This was consistent with the conclusions of the 1995 *Clients First* report.

2.32 The Strategic Adviser commented that, in the desktop environment, the degree of geographic concentration and commonality of operating platforms and applications can have a significant impact on the cost of service delivery. Synergies could arise from the willingness of agencies to transition to common or standardised systems. It was also noted that the results of the OGIT/DOF Evaluation suggested that agencies would receive more favourable pricing if larger volumes of business were offered to industry. This was due largely to economies of scale in the cost of service delivery that vendors could achieve at higher volumes, and the greater negotiating leverage agencies could have in contracting for larger volumes of business. It was noted that, in general, smaller agencies that join agency groups with high aggregate volumes should benefit the most from economies of scale.

2.33 The Strategic Adviser concluded that the results of the OGIT/DOF Evaluation indicated that there were significant economies of scale in the desktop environment through to at least 5,000 personal computers, after which the benefits of economies of scale begin to level off.[58] This

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58 The report of the OGIT/DOF Evaluation noted that specific desktop/network pricing data provided by two vendors had suggested that direct pricing benefits of fifteen to thirty percent may be achievable for small agencies from clustering up to a level of around 4000 to 5000 personal computers. It also noted that improved benefits could still be expected to be achievable for larger agencies and clusters through the leverage such large volumes can provide in the competitive tendering process.

analysis provided a threshold target for the formation of agency groups with no mainframe requirement. An equivalent threshold was not established for mainframe volume. ANAO did not identify quantitative or qualitative analysis of the implications for agencies' operational efficiency of achieving mainframe and/or desktop volume thresholds through the grouping of particular agencies under a single contract.[59]

2.34 The cost of IT services delivered under a grouping strategy will not only be a factor of economies of scale, but also of the quality of service required, and the degree of commonality between the business requirements of grouped agencies. Comparison in the OGIT/DOF Evaluation of the indicative pricing provided by vendors in response to the RFI with agency baseline information highlighted that the level of savings achieved by agencies through the outsourcing of desktop services could be expected to be highly variable.[60] To the extent that the agency baseline data used in the Evaluation accurately captured existing agency costs for comparable levels of service with those reflected in the costs of other agencies and in the indicative vendor pricing provided, the analysis suggests that some agencies were operating at highly competitive levels, with others at a cost disadvantage. To the extent that the cost and price data used in the Evaluation did not reflect comparable levels of service, the reliability of savings estimates made on the basis of that data would be diminished.[61]

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59 Although the grouping of agencies to achieve a quantitative threshold will provide economies of scale effects, it can be expected that there will, on occasion, be competing priorities within a group of agencies contracted to an ESP under a single contract. The ability and/or readiness of the ESP to respond appropriately to each agencies' operational priorities may be affected by the nature of agency groupings. For example, the experience of smaller agencies within Cluster 3 has been that, although they have a direct relationship with the ESP at the operational level, the capacity of the ESP to respond to their operational requirements in a timely manner has been significantly affected at times by the overriding operational imperatives of other, larger Cluster agencies. The extent to which this may offset economies of scale benefits (in terms of operational efficiency) will depend upon the extent to which these sort of delays impact on agencies' end users. Consideration of this sort of issue could enhance the analysis of quantitative economies of scale thresholds.

60 The agencies represented in the sample used were described as covering a broad spectrum of scale, dispersion and complexity of support and network communication requirements.

61 The OGIT/DOF Evaluation Report noted that it appeared that respondents to the RFI initially expected to offer an 'industry standard' level of service, with agencies negotiating individual requirements after the contract had been let. It also noted that, for the midrange and desktop/ network environments, many agencies did not clearly specify the level of service currently delivered or required.

2.35 A number of industry respondents to market research commissioned by OASITO in March 1998 commented that economies of scale and consolidation savings were not as readily available in the midrange and desktop areas, and that it may be difficult to achieve savings through standardisation where there are multiple agencies involved. Respondents also commented that some agencies were running parts of the IT infrastructure at, or close to, best practice.

Effectiveness of agency groupings

2.36 Experience suggests that, within the policy context, there are areas in which the structure of agency groupings could be enhanced to better support agency business requirements. For example, although the tender evaluation identified significant expected savings for Cluster 3 agencies, it may not be an optimal grouping in some respects. The agencies in Cluster 3 are quite disparate in their size and business requirements.[62]

2.37 Cluster 3 includes large, geographically-dispersed, Budget-funded agencies (such as DIMA and AEC); small, commercially-focused agencies (such as AGAL, AUSLIG and IP Australia); and, for the first 18 months, the NCA, which had more stringent security requirements than the rest of the Cluster.[63] These differences have contributed to a range of operational difficulties for both Cluster agencies and the ESP.[64]

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[62] This was in part influenced by events during the RFT development stage (when the former Department of Administrative Services, a significant member of the Cluster, was reorganised to form DOFA with the former Department of Finance), and by the incentive for agencies, particularly DIMA and AEC, to join the first tender under the Initiative in order to provide a means to rapidly address their need to upgrade aging IT infrastructures.

[63] Grouping agencies with significantly different security requirements has the potential to increase costs to the ESP which may, over time, reduce the overall value received by the Commonwealth. For example, as a former bureau customer of DOFA, the NCA was a member of Cluster 3 for the delivery of mainframe requirements for just over a year. It represented less than 3 percent of Cluster mainframe services, but its security requirements necessitated the provision of a dedicated mainframe site. This removed any capacity for the ESP to create economies through the consolidation of requirements, and increased the ESP's management overhead. The security requirements attaching to the NCA data also precluded the ESP from gaining the access necessary to render invoices to the NCA based upon actual mainframe usage, with charges being based upon the usage estimates included in the Cluster 3 RFT. A further example of the operational implications of grouping agencies with different security requirements was the requirement for Cluster 3 agencies to operate at a standard level of security for the transfer of data to the Year 2000 testing environment established by the ESP. Because the standard must be set at the highest level required by a Cluster agency, this created additional operational imposts for agencies with lower security requirements.

[64] In June 1999, AGAL commented that the Cluster 3 mix of large and small agencies was probably not the best outcome for it, noting that the Cluster Agreement attempted to cater for the requirements of all agencies, and that some of the compromises had resulted in less than optimum coverage for an individual agency.

2.38 In August 2000, the Cluster 3 ESP advised ANAO that:

> [It] *agrees that the Cluster 3 agency grouping may not have been optimal and believes that the various differences have contributed significantly to the complexity of the task. Both to the period and difficulty of transition and to the achievement of some contractual expectations. This experience has proved to be very difficult for both agencies and* [itself].

2.39 An issue for smaller agencies within a group can be the potential for the ESP to concentrate its service delivery efforts on the larger agencies. Concerns expressed by the smaller agencies within Cluster 3 during the first year of service delivery suggested that this was a factor in the initial implementation of the Cluster. The commercially-focussed agencies in the Cluster have also expressed concern at various times about the implications for their commercial arrangements and relationships arising from service delivery failures by the ESP.[65]

2.40 Differences in security requirements have also contributed to operational issues arising under the Group 5 Agreement, where PM&C's more stringent security requirements have contributed to the difficulties experienced by the ESP in implementing its proposed solution.[66] The Group 5 ESP advised ANAO that:

> *The tender indicated that the security requirements for in-scope services was the same for PM&C as for all of the other agencies. It was acknowledged that the higher security PM&C facilities services (eg their secure LAN) would continue to be operated and maintained by PM&C. It was not until the Handover Date that it became apparent that PM&C security provisions for LAN and WAN connections would need to be of higher security than the other agencies.*

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[65] In June 1999, AGAL observed that it is a small agency with very specific requirements that are not typical of most of the other agencies, particularly the two largest (DIMA and AEC). It also noted that it operates in a commercial environment and, as such, relies heavily upon IT to provide a competitive edge. It considered that the current cluster arrangements and the relationship with the ESP did not necessarily promote this objective. AGAL noted that further deterioration of the ESP's performance would lead to it failing to meet its service level obligations, thus placing contracts with its clients in jeopardy. Similarly, IP Australia advised the Cluster 3 Contract Management Office in July 1999 that its productivity, and the productivity of its major customers, were directly impacted by any lack of availability of the mainframe services provided by the ESP. IP Australia, which funds its operations through receipts earned from customers, considered a conservative estimate of the cost to it of system unavailability between October 1998 and April 1999 had been over $200,000 (this compares to payments to the ESP in 1998-99 of $596,000).

[66] The *IT Infrastructure Security Framework for Outsourcing* (the DSD framework) jointly released by the Defence Signals Directorate (DSD), the Attorney-General's Department and OGIT in August 1997, recommended that agencies being grouped should have similar confidentiality, integrity and availability requirements.

2.41 The tenders reviewed in this audit also provided lessons for consideration in the formation of future offerings to the IT outsourcing market. The DEETYA/EN RFT was discontinued after the single tender received was assessed as not offering a cost-effective solution. OASITO's March 1998 market research indicated that the low level of interest related primarily to a lack of growth potential in the package offered, perceptions of advantage to an incumbent supplier, and uncertainty associated with the impending implementation of the employment services market.

2.42 Initial planning by OGIT had grouped DEEYTA with the ATO, but it was subsequently agreed that a new cluster would be formed around DEETYA, with the ATO forming a later, separate tender. DEETYA had identified a requirement to have the IT outsourcing issue resolved prior to the implementation of the Government's employment services reforms (which relied heavily on IT infrastructure). DEETYA's required timing could not be met within the clustered arrangement with the ATO. In March 1998, OASITO acknowledged that the decision to establish DEETYA/EN, with its low growth outlook, as a single group for bidding was a commercial error.

2.43 As changes in departmental arrangements occur over time, there will be a need for existing groups to be modified and rationalised to maintain operational effectiveness.[67] The emerging use of electronic service delivery in the public sector will increase the need for agencies engaged in the delivery of related or complementary services to be able to cost-effectively integrate those services or exchange data across their IT infrastructure. Existing groups may not be optimal from that perspective.

2.44 The Cluster 3, ATO and Group 5 Agreements provide the capacity for the existing agency membership to be changed, and for services to be removed or added to the Agreement at the convenience of the Commonwealth. Such changes are subject to the terms of each Agreement, including termination for convenience charges, equipment lease termination charges and volume-based thresholds for increasing or reducing unit pricing. The cost-effectiveness of changing the membership of a group during the initial outsourcing Agreement will depend upon individual circumstances, but in many cases it will probably be most cost-effective to make substantial changes to group membership at the expiration of existing Agreements.

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67 The initial grouping of agencies under the IT Initiative, together with the impact of changes in departmental arrangements, has resulted in at least one portfolio spanning more than one outsourced provider. Some agencies within the Industry, Science and Resources portfolio are covered by the Cluster 3 Agreement, the Department itself is included in the Group 5 Agreement, and other elements of the portfolio will be in separate arrangements (such as Australian Geological Survey Organisation which was moved to the portfolio during the Group 5 tender evaluation). This has created operational difficulties in areas that cross the boundaries of the IT infrastructure services provided under each Agreement, such as human resources.

2.45 ANAO considers that the effectiveness of Commonwealth IT outsourcing arrangements would benefit from the application of coordinated, on-going analysis to identify opportunities to cost-effectively optimise the composition of existing groups, either during the initial contract term, where cost-effective, or in the future re-tendering of outsourcing agreements. In particular, such analysis should consider the appropriateness and effectiveness of combining agencies of disparate size and business focus under a single Agreement, and opportunities to rationalise the provision of IT services to agencies with common portfolio and/or business requirements. Such recognition and flexibility might also provide greater scope for enhancing business performance, as well as achieving the expected whole-of-Government benefits. Overall performance is likely to be enhanced where strategies are complementary and action is mutually supportive of required outcomes.

2.46 **Finding:** Experience suggests that, within the policy context, there are areas in which the structure of agency groupings could be enhanced to better support agency business requirements, including in terms of the relative size, business-focus, funding arrangements and security requirements of grouped agencies. Such recognition and flexibility might also provide greater scope for enhancing business performance, as well as achieving the expected whole-of-Government benefits. Overall performance is likely to be enhanced where strategies are complementary and action is mutually supportive of required outcomes. Experience has also provided lessons for consideration in the formation of future offerings to the IT outsourcing market. As changes in departmental arrangements occur, there will be a need for existing groups to be modified and rationalised to maintain operational effectiveness.

2.47 ANAO considers that the effectiveness of Commonwealth IT outsourcing arrangements would benefit from the application of coordinated, on-going analysis to identify opportunities to cost-effectively optimise the composition of existing groups, either during the initial contract term, where cost-effective, or in the future re-tendering of the outsourcing agreements. In particular, such analysis should consider the appropriateness and effectiveness of combining agencies of disparate size and business focus under a single IT outsourcing Agreement, and opportunities to rationalise the provision of IT services to agencies with common portfolio and/or business requirements. Such recognition and flexibility might also provide greater scope for enhancing business performance, as well as achieving the expected whole-of-Government benefits. Overall performance is likely to be enhanced where strategies are complementary and action is mutually supportive of required outcomes.

Recommendation No. 2

2.48 ANAO *recommends* that, as part of the management of Commonwealth IT outsourcing contracts, relevant agencies institute a framework to support the identification of opportunities to enhance the synergistic benefits available from the composition of agency groupings, either during the initial contract term, where cost-effective, or in the future re-tendering of the outsourcing agreements.

2.49 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response***: **Agree**. Agencies agree to pursue synergistic benefits between agencies within existing groups or with other portfolio agencies during the term of the agreements and in any re-tendering activity.

Evaluation of IT Initiative

2.50 The consolidation and outsourcing of agency IT infrastructure under whole-of-Government arrangements is a significant Government initiative which represents a major change in the strategy applied to the delivery to agencies of important business enablers. It is important, therefore, that the costs, benefits and outcomes resulting from the IT Initiative are appropriately evaluated and reported to inform future management in this area. That requirement relates to outcomes achieved at both the whole-of-Government level, and by the agencies involved in each outsourcing arrangement.

2.51 Under the proposal for the IT Initiative approved in the 1997-98 Budget context, it was agreed that the costs and benefits of consolidation and outsourcing under whole-of-Government arrangements would be progressively evaluated as competitive tendering for individual clusters was completed. An evaluation strategy for the Initiative was to be developed and agreed between OGIT and the (then) Department of Finance, now DOFA. Based on the documentation provided to ANAO, as at June 2000 such a framework had not been agreed between DOFA and the central coordinating agency for the Initiative (OGIT, and then OASITO).

2.52 In October 1997, DOFA advised OGIT that it considered it particularly important that an agreed performance monitoring framework be established as early as possible. This would enable the quantitative and qualitative measures essential to the assessment and reporting of outputs and outcomes of the IT Initiative to be agreed, and appropriate data collection mechanisms to be integrated into the competitive tendering and business case evaluation processes.

2.53 DOFA proposed a performance monitoring and evaluation framework which sought to ensure that consistent and appropriate qualitative and quantitative performance information was collected and analysed to enable timely and objective assessment of how well the objectives for the IT Initiative were being achieved at an aggregate level, for particular clusters and, in some cases, agencies. It was suggested that performance measures should focus on the qualitative and quantitative outcomes from competitive tendering, including financial savings; other identified and realised benefits from consolidation and outsourcing; reduced costs of competitive tendering process and downstream contract management for agencies as a consequence of clustering; and measurable and realisable industry development benefits.

2.54 In February 1998, OASITO advised DOFA that a simple one-size-fits-all methodology for data collection and business case evaluation would not be possible. OASITO advised that its preference was to adopt, in consultation with DOFA, a simple process during evaluation short-listing that tracked the IT Initiative's performance against the core accountability and reporting requirements. The expected deliverable was to be an IT Initiative progress report (authored by OASITO and DoFA) provided to the Minister for Finance and Administration for consideration with the recommended shortlist.

2.55 Throughout the Initiative, OASITO has provided periodic written briefings to the Minister regarding the strategic planning for its implementation, and as covering information to the submission of evaluation reports and recommendations for individual tenders. These briefings included advice regarding the extent to which Government objectives would be satisfied by the selection of the recommended tenderer. On occasion, OASITO also provided information on aspects of the Initiative that may benefit from an alternative approach in future tenders. However, these briefings have not represented an objective evaluation of the costs and benefits of the whole-of-Government consolidation and outsourcing strategy underpinning the IT Initiative. The proposed 'IT Initiative progress report', co-authored with DOFA, has not been developed.

2.56 Implementation of the IT Initiative commenced in April 1997. As at June 2000, there had yet to be a comprehensive assessment of the costs and benefits of consolidation and outsourcing under whole-of-Government arrangements in the terms proposed at the time the Initiative was approved. OASITO advised ANAO that it would be premature to undertake a broad assessment of outcomes from the Initiative before a reasonable number of contracts were in place and transitioned to steady state operations. OASITO noted that it was approaching the time when such a review would be appropriate. In June 2000, DOFA advised ANAO that it was still its intention to implement a performance evaluation framework of the nature proposed by it in October 1997, and that it was currently working with OASITO to finalise an evaluation framework for the Initiative.

2.57 ANAO notes that the original intention was that the costs and benefits of consolidation and outsourcing under whole-of-Government arrangements would be progressively evaluated as competitive tendering for individual clusters was completed. The IT Initiative is a very significant Government initiative affecting hundreds of millions of dollars in Commonwealth expenditure. As such, ANAO considers that there would be merit in instituting an agreed evaluation framework to enable effective evaluation of the costs and benefits of the strategy employed under the Initiative, as was envisaged at the time the Initiative was approved.

2.58 As a consequence of the initial implementation of the IT Initiative, there will be an ongoing need to periodically evaluate and re-tender a large number of IT outsourcing arrangements. In this environment, ANAO considers that there would also be considerable merit in the development of an agreed performance monitoring and evaluation framework to assist in assessing and reporting in a consistent and comparable manner on the outcomes achieved at the agency level under each outsourcing contract. This would provide a comprehensive basis for analysing the costs and benefits of the grouping, contracting and management strategies employed by each group to identify opportunities for future enhancement of those strategies.

Lessons learned

2.59 It is also important that the collective knowledge gained through each tender process is captured and maintained. Internal evaluation structures can provide a useful means for incorporating improvements in subsequent transactions. In some respects, this has been an area of ongoing development as the body of knowledge held within OASITO and other agencies has accumulated over the course of the IT Initiative.

2.60 The processes in place within OASITO to capture lessons learned have included internal end-of-project review sessions. The face-to-face involvement of key advisers in those sessions was seen as an important mechanism for the development of ongoing expertise and capability within the Commonwealth. OASITO advised ANAO that, in addition to making routine process adjustments on a real-time basis, lessons learned sessions were held for the Cluster 3 project in May 1998, the ATO and Group 5 projects in May 1999 (which formed part of a broader review and planning session involving executives from OASITO, Group 5 and the ATO), and Group 8 in February 2000.

2.61 ANAO noted that, in carrying out assets sales, OASITO generally incorporates into its agreements with key advisers, a contractual requirement for a transaction report to be prepared within 30 days of the completion of the assignment. The transaction report is in the nature of an evaluation of the lessons learned that will facilitate ongoing improvements in subsequent assignments. OASITO advised ANAO that given the involvement of the Strategic Adviser and Legal Adviser in these interactive continuous improvement processes, it was unnecessary to require separate written reports from the advisers to the IT Initiative.

2.62 However, it appears that there are still opportunities for the effectiveness of the lessons learned processes undertaken by OASITO to be further enhanced. In May 2000, the Group 5 Contract Management Office (Group 5 CMO) advised ANAO that, based on its informal discussions with, and the questions received by it from, agencies involved in tenders conducted after Group 5, there was some evidence that the existing lessons learned processes were not producing the desired outcomes.

2.63 The Group 5 CMO considered that, given the limited resources available within OASITO and the strong incentive for participant agencies/groups to optimise the outcomes of their individual tender processes, there would be some merit in OASITO formally recording the lessons learned at the end of each tender process, and making those records available to participants in subsequent tenders. The Group 5 CMO also recommended that processes be put in place to ensure that significant changes to RFTs were carried through, or at least openly considered, by later groups. It was suggested that a simple way to do this would be to provide future groups with a 'library' of previous RFTs and contracts, including their schedules (with prices deleted as appropriate).

2.64 **Finding:** Under the proposal for the IT Initiative approved in the 1997-98 Budget context, it was agreed that the costs and benefits of consolidation and outsourcing under whole-of-Government arrangements would be progressively evaluated as competitive tendering for individual clusters was completed. As at June 2000, OASITO and DOFA had yet to agree an evaluation framework for the comprehensive assessment of the costs and benefits of consolidation and outsourcing under whole-of-Government arrangements in the terms envisaged at the time the Initiative was approved. ANAO considers that there would be merit in instituting an agreed framework to enable effective evaluation of the costs and benefits of the whole-of-Government strategy employed under the Initiative, as was envisaged at the time the Initiative was approved. ANAO considers that there would also be considerable merit in the development of an agreed performance monitoring and evaluation framework to assist in assessing and reporting in a consistent and comparable manner on the outcomes achieved at the agency level under each outsourcing contract.

2.65 OASITO has undertaken a range of processes directed at ensuring the collective knowledge gained through the tender processes conducted is captured and maintained. Those processes have included internal end-of-project reviews and lessons learned sessions which included the involvement of key advisers. The experience of some agencies suggests that there are opportunities for the effectiveness of the lessons learned processes undertaken by OASITO to be further enhanced.

Recommendation No. 3

2.66 ANAO *recommends* that:

a) OASITO and DOFA agree a timetable for the finalisation and implementation of an evaluation strategy for assessing whole-of-Government outcomes achieved under the IT Initiative;

b) relevant agencies develop an evaluation strategy for consistently assessing and reporting outcomes achieved under IT outsourcing arrangements from the perspective of agency groups and individual agencies; and

c) OASITO considers further enhancing its lessons learned processes through the development of mechanisms for the collection, distribution and maintenance of documented lessons learned material, together with appropriate request for tender and contractual material, arising from previous IT outsourcing tender processes to assist agencies undertaking subsequent processes.

2.67 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response***:
  - Part (a): **Agree.** DOFA and OASITO will review the scope of the proposed evaluation strategy for assessing whole-of-Government (WOG) outcomes under the IT Initiative. The review of scope would focus on those areas where ongoing WOG monitoring can be most effective.
  - Part (b): **Agree.** The respondents support efforts to make use of monitoring and reporting provisions in service agreements to assess outcomes achieved under IT outsourcing arrangements.

– Part (c): **Agree.** OASITO will continue to explore opportunities to further enhance its existing lessons learned processes through improved clarity in documenting these processes.

3. IT Initiative Management

This chapter discusses the cost of implementing the IT Initiative and the engagement and use of external expert advisers.

Cost of implementing IT Initiative

3.1 The implementation phase of the IT Initiative commenced following announcement of the Initiative in April 1997. During that phase, costs were incurred by the coordinating agency (now OASITO), the agencies involved in each tender process, and other agencies required to provide particular skills to the process. Under the financial evaluation model applied in the Initiative, those costs were not included in the business case analysis for each tender.[68] The estimated costs to agencies of re-tendering at the end of the initial Agreements were included in the financial evaluation.

3.2 The cost to OGIT and, subsequently OASITO, of coordinating implementation of the IT Initiative has exceeded the original budget allocated. In the 1997-98 Budget, OGIT was provided with funding of $13 million to oversee the implementation of the IT Initiative, including engaging a pool of specialist advisers. The funding was transferred to OASITO in November 1997 with responsibility for the Initiative.

3.3 In the 1999-2000 Budget, OASITO received additional funding for the IT Initiative, increasing the budget for 1999-2000 by $14.8 million and providing new funding of $9.8 million for 2000-01. This increased the total budget for OGIT/OASITO's role in implementing the Initiative to an estimated $37.6 million. The increased costs of implementing the IT Initiative have been primarily due to:

- the extended timeframe for the implementation of the Initiative;
- greater than anticipated levels of effort on the part of OASITO and its advisers in each tender process, combined with an expanded role as set out in the revised roles and responsibilities advised in January 1999[69]; and

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68 OASITO advised that these costs are not included in the business case analysis as they are sunk costs that will be incurred regardless of the outcome of the process, and have been incurred as a result of the Government's policy decision to require outsourcing via competitive tendering.

69 In October 1998, the Strategic Adviser advised OASITO that additional resources would be required if OASITO and its advisers were to take a more active role in defining and/or approving agency technical requirements and cost baselines, noting that '*…key resources have been stretched thin for most of the Initiative and this represents a significant risk to the success of the IT Initiative.*'

- use of OASITO's advisers to a greater extent and for a longer timeframe than was envisaged at various points throughout the Initiative.

3.4 As at May 2000, six major tenders had been completed, and considerable preparatory and/or evaluation work undertaken by OASITO and relevant agencies on a number of other tenders. Contracts representing the provision of about $1.2 billion in IT&T services over five years had been executed, with the Group 1 tender in tender evaluation and the Group 9, 10, 11 and Defence portfolio tenders at various stages of preparation and RFT development. The estimated total direct cost of implementing the IT Initiative to 31 May 2000 amounted to at least $40.38 million or about 3.4 percent of the value of contracts awarded to that time.[70] This comprised OGIT/OASITO running costs of $7.39 million, advisers' fees and expenses of $25.78 million and agencies' direct costs of participation in the Cluster 3, DEETYA/EN, ATO and Group 5 tenders of $7.21 million (see Figure 3.1). These implementation costs include costs incurred by OASITO <u>for other tenders completed or in progress or preparation</u> as at May 2000, but excludes participation costs incurred by agencies involved in tenders other than those considered in this audit.

[70] These implementation costs include all costs incurred to date by OGIT/OASITO in managing, and subsequently monitoring, the implementation of the IT Initiative, including development of project guides, manuals and template documentation that will be re-used in future tender processes; and establishment of the Small Agency Program and provision of implementation assistance to agencies within that program. The August 2000 DOFA whole-of-government response to the section 19 proposed audit report advised that implementation costs incurred to May 2000 also included liaison and assistance to the Department of Foreign Affairs and Trade, AusAid and Austrade as they undertake an internal consolidation exercise.

Figure 3.1

Estimate of IT Initiative implementation costs April 1997 to May 2000

		$m	$m
OGIT/OASITO (relates to all work undertaken on the 12 planned tenders as at 31 May 2000)			
	Running cost expenditure[1]		7.39
Advisers			
	Strategic Adviser[2]	15.82	
	Legal Advisers	5.23	
	Financial Advisers	2.62	
	Industry Development Advisers	1.17	
	Probity Auditor	0.36	
	Evaluation Adviser	0.12	
	Other consultants/ESPs	0.46	
Total—Advisers			25.78
		TOTAL—OGIT/OASITO	**33.17**
Estimated direct costs—Cluster 3, DEETYA, ATO & Group 5 agencies only[3]			7.21
TOTAL ESTIMATED DIRECT COSTS to 31 MAY 2000			**40.38**

[1] OASITO running cost expenditure as at April 2000. This expenditure relates to personnel and operating costs.

[2] Excludes fees and expenses of $1.25m incurred during the 1996-97 Evaluation phase.

[3] Includes agencies involved in Cluster 3, DEETYA/EN, ATO and Group 5 tenders only. Excludes agencies involved in subsequent tenders. Estimates do not include costs incurred by agencies that have dropped out of tenders part way through. Estimate for Cluster 3 agencies—$2.06m (does not include DOFA or DOFA bureau customers); DEETYA—$1m, ATO—$2.7m and Group 5 agencies—$1.45m.

Source*:* ANAO analysis of information obtained from OASITO, DOFA and agencies.

3.5 Payments to advisers to the IT Initiative between April 1997 and May 2000 totalled some $25.78 million. This excludes payments of $1.25 million made to the Strategic Adviser during the 1996-97 OGIT/DOF Evaluation phase, and costs for other advisers incurred but not yet paid as at 31 May 2000.

3.6 Because the costs incurred by agencies in preparing for and participating in tender processes are not included in the business case analysis, many agencies have not routinely recorded those costs. Based on estimates of personnel involvement and other costs provided by agencies involved in the Cluster 3, DEETYA/EN, ATO and Group 5 tenders, ANAO estimated the direct implementation costs incurred by those agencies at $7.21 million. No estimate was made of the implementation costs incurred by agencies involved in subsequent tenders.

3.7 **Finding:** As at May 2000, six major tenders had been completed, and considerable preparatory and/or evaluation work had been undertaken by OASITO and relevant agencies on a number of other tenders. Contracts representing the provision of about $1.2 billion in IT&T services over five years had been executed, with the Group 1 tender in tender evaluation and the Group 9, 10, 11 and Defence portfolio tenders at various stages of preparation and RFT development. The expected costs to OGIT/OASITO of implementing the IT Initiative have increased nearly threefold over the $13 million originally allocated in the 1997-98 Budget. In the 1999-2000 Budget, the total budget for OGIT/OASITO's role in implementing the Initiative was increased to an estimated $37.6 million. As at May 2000, the estimated direct cost to date to OGIT/ OASITO of implementing the IT Initiative amounted to $33.17 million. Agencies' direct costs of participating in the Cluster 3, DEETYA/EN, ATO and Group 5 tenders amounted to an additional $7.21 million. The estimated total direct cost of implementing the IT Initiative to 31 May 2000 amounted to at least $40.38 million or about 3.4 percent of the $1.2 billion in contracts awarded to that time. These implementation costs include costs incurred by OASITO for other tenders completed or in progress or preparation as at May 2000, but excludes participation costs incurred by agencies involved in tenders other than those considered in this audit.

Strategic adviser

3.8 The IT outsourcing tender processes conducted by OASITO are complex, resource intensive activities undertaken within tight timeframes. OASITO relies heavily on its major advisers and other consultants to assist it to progress the IT Initiative and each tender process. In these circumstances, prudent contracting and management practices are important to ensure accountability and the achievement of value-for-money. This is particularly important when contracting for advisers with a pivotal role in the process, such as the Strategic Adviser.

3.9 Since mid-1996, a United States-based firm has been engaged to provide strategic advice and technical assistance to the IT Initiative. This engagement has consisted of three main phases: June 1996 to June 1997 (Phase 1); July 1997 to June 1998 (Phase 2) and July 1998 to present (Phase 3).[71] As at 31 May 2000, total costs of $17.07 million[72] (US$11.07 million) had been incurred in respect of the Strategic Adviser

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71 OGIT was responsible for the management of this consultancy until responsibility for the IT Initiative was transferred to OASITO in November 1997.

72 Includes $1.25m in fees and expenses in the OGIT/DOF Evaluation phase and payments of $15.82m for services provided in the implementation phase up to 31 May 2000.

since June 1996. This comprised an estimated $16.93 million in fees and $141 000 in reimbursed expenses. Payments to the Strategic Adviser accounted for over 60 per cent of OGIT/OASITO's total expenditure on advisers to May 2000.

Engagement processes

3.10 For the period June 1996 to June 1998, the Strategic Adviser was paid fees and expenses of $7.18 million to provide services in respect of the development and implementation of the IT Initiative. These assignments were not competitively tendered by OGIT, with the reasons for this not being documented. The Strategic Adviser was initially engaged by OGIT in mid-1996 (Phase 1) to provide advice on the viability of "clustering" as a means of achieving cost savings and to review issues associated with IT outsourcing and internal agency consolidation. The ANAO was unable to locate any Commonwealth record of the selection process used to initially identify and engage the Strategic Adviser, nor was there any evidence of a contract being signed. Subsequently, the Strategic Adviser was re-engaged, again without competitive tender, to assist in developing the principles for, and implementation of, the OGIT/DOF Evaluation conducted between August 1996 and March 1997. In this instance also, there is no evidence of a written contract between the parties.

3.11 In June 1997, OGIT prepared an Initiative implementation and strategy brief which recommended that the incumbent adviser be appointed as the 'Outsourcing Consultant', a role now described as the Strategic Adviser. The rationale provided for this recommendation related to assessments regarding the incumbent adviser's '*...unique international experience*', absence of conflicts of interest and previous experience on the project, and of the potential implications for the progress of the Initiative from appointing an alternative firm at that time. There was no other documentation supporting this analysis.

3.12 There was no documented consideration of the value-for-money represented by the fees proposed by the incumbent adviser, or of the rationale for the fee structure, which involved significant monthly fees of up to US$85 000 per individual per month. The brief to the Minister recommending the engagement did not identify the scale of costs involved. Nor did it make it clear that this was a sole source appointment.

3.13 A contract for the provision of strategic advice and assistance by the Strategic Adviser was signed by OGIT on 3 July 1997 (Phase 2),[73] representing the first written agreement for this consultancy. The contract covered the period 1 July 1997 to 30 June 1998. It specified three personnel who would undertake the consultancy work on a fixed-price quotation basis. The fees were US$85,000 per month for each of two[74] of the personnel and US$65,000 per month for the third. Other personnel were to be used as mutually agreed on an hourly fee basis.

Competitive tender

3.14 On expiration of the July 1997 contract with the Strategic Adviser, OASITO conducted the first competitive tender conducted in association with what was, by this stage, a multi-million dollar consultancy role important to the implementation of a significant Government initiative. It was conducted as a restricted tender, with seventeen firms provided with an Invitation to Submit Proposal (ITSP) on 15 May 1998 to provide strategic advice, project management and technical assistance[75] to the IT Initiative for eighteen months from July 1998 to December 1999 (Phase 3). Candidates were invited to tender for all or part of these services.

3.15 OASITO advised ANAO that it considered that it had conducted an effective competitive process to the extent that it obtained offerings from a comprehensive cross section of the consultancy organisations claiming to have skills in the area concerned. The firms to whom OASITO sent an ITSP appear to have been largely drawn from its general consultancy register for asset sale services.[76] OASITO's consultancy register was based on respondents to national advertisements placed to garner expressions of interest for future consultancy services. The most recent advertisement prior to the May 1998 competitive tender was placed in September 1997 by the (then) Office of Asset Sales (OAS), prior to the transfer of responsibility for the IT Initiative to OAS, and so was targeted at firms with expertise relevant to asset sales. OASITO advised ANAO that additional IT-focused firms were also on the consultancy register.

[73] Copies of the contract made available to ANAO were signed by OGIT but not by the Strategic Adviser.

[74] The continued need for the services of one of these consultants was to be reviewed on or before 1 October 1997. That individual remained with the consultancy until June 1998.

[75] In addition to strategic advice, the incumbent Strategic Adviser had been providing, in conjunction with other advisers, technical assistance to the implementation of the IT Initiative. This included assistance in the development of tender documents and agency cost baselines. The Strategic Adviser had also been performing the role of lead negotiator.

[76] An initial list of nine potential bidders developed in May 1998 was described as also including organisations that had made direct representations to OASITO. The organisations to which this reference applied were not identified and it is not known whether those organisations remained on the final list of potential bidders.

However, the process used by OASITO to identify such firms for inclusion on the register, and their experience in the specialist field under consideration, was not documented. OASITO also advised ANAO that the inclusion of a number of major consulting firms in the tender was intended to provide access to international IT outsourcing expertise.[77]

3.16 Potential candidates for the Strategic Adviser consultancy were given ten business days after receipt of the ITSP to respond, with the proposals to be developed on the basis of the limited information provided in the ITSP and other publicly available information on the Initiative. The appropriateness of this timeframe should be considered in light of the provision within the ITSP reserving the right of the Commonwealth to make its selection on the basis of the written submissions provided. Responses were received from ten firms. OASITO prepared a summary of the proposals and provided it to Tender Evaluation Committee (TEC) members[78] for discussion. Based on these discussions, six firms were shortlisted for interview.

3.17 The incumbent Strategic Adviser's fee proposal was stated in United States dollars and reflected the fee structure existing under their previous contract.[79] The fees proposed for the eighteen month period under consideration were A$6.5 million, some A$2 million (44 percent) higher than those proposed by the next ranked respondent.[80]

3.18 The TEC considered the next ranked respondent to represent a relatively lower cost/higher risk approach, but one which did not have its confidence even if all key nominated personnel were available. The TEC recommended that the most cost-effective solution for the IT Initiative would be to engage the incumbent Strategic Adviser for a six month period between 1 July 1998 to 31 December 1998, and then on a specific task engagement basis as individual needs arose from 1 January 1999 to 31 December 1999. In making that assessment, the TEC noted that tasks faced by the Initiative over the ensuing six months would present serious problems if high quality strategic and technical resources were not available to the end of 1998.[81]

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77 OASITO had advised its Minister in February 1998 that it was *'… giving thought to how we might adequately test the market for* [the Strategic Adviser's] *skills for the period after 30 June 1998, without risking losing the services of* [the Strategic Adviser] *if such a test fails to locate a satisfactory alternative.'*

78 The TEC was chaired by OASITO and included two business representatives.

79 One of the eleven selection criteria against which the proposals were assessed related to *'…the capacity to offer daily charge rates that recognise the volume and regularity of work involved.'* The ANAO notes that the monthly charge rates applying in respect of the core Strategic Adviser personnel have not changed from those applying to the initial short-term engagement with OGIT in 1996.

80 Based on an exchange rate of $A1.00/$US 0.60.

3.19 OASITO signed a contract with the Strategic Adviser on 28 August 1998 for the provision of strategic and technical advice for the six-month period 1 July 1998 to 31 December 1998. Fees were to be paid at the rate of US$85,000 per month (A$1.7 million per annum) for a partner-level adviser and US$65,000 per month (A$1.08 million per annum) each for two other advisers. The contract also specified that if further assistance was required after 31 December 1998 in respect of negotiations with tenderers, those services would be provided on a basis to be agreed by the Strategic Adviser partner. Fees would be paid based on an hourly rate of US$375, capped at a daily rate of US$4,500. The six-month engagement to 31 December 1998 recommended by the TEC has been extended on a number of occasions, with additional full-time advisers added, and was still in operation in July 2000.[82]

Foreign currency risk

3.20 From July 1997, OGIT, and subsequently OASITO, had contracts in place that specified monthly fees payable in Unites States Dollars. Contracts requiring foreign currency payments expose the Commonwealth to foreign exchange risk and reduce the certainty associated with the cost of the contract. Neither OGIT nor OASITO explicitly quantified the exchange rate exposure or formally examined possible ways of managing the associated risk. ANAO raised this issue with OASITO in December 1999. Although in the Telstra 2 sale OASITO sought to minimise its exposure to foreign exchange risk, OASITO decided to maintain an open exposure in relation to payments to the Strategic Adviser. In the subsequent months the exchange rate deteriorated. In June 2000, the Government announced that it had established a task force to re-examine the Commonwealth's approach to foreign exchange risk management.[83]

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[81] The TEC report stated that: '*On balance, the Committee considered that when confronted with the huge differential in what was offered* by [the incumbent Strategic Adviser] *in comparison to other proposals, and the difficult tasks ahead of the project in the next six months, it would place the project in too much risk to engage a firm other than* [the incumbent Strategic Adviser] *during those six months.'*

[82] Extensions were agreed between the parties in December 1998 (to the end of February 1999); in March 1999 (to end of June 1999) ,in June 1999 (to end of December 1999). The latest extension takes the consultancy to June 2000. The extensions were approved on the basis that OASITO required the Strategic Adviser's continued services to progress the Group 5, Health Group, Group 8 and Centrelink projects, and to commence Groups 6 and 11.

[83] The task force was to examine the recommendations of Audit Report No. 45 1999-2000, *Commonwealth Foreign Exchange Risk Management Practices*, including a Commonwealth-wide risk management policy and the need for consistent and considered risk management approaches by agencies.

3.21 **Finding:** The Strategic Adviser accounted for some 55 per cent of OGIT/OASITO's total expenditure on advisers to 31 May 2000. For the period June 1996 to June 1998, the Strategic Adviser was paid fees and expenses of $7.18 million to provide services in respect of the development and implementation of the IT Initiative. These assignments were not competitively tendered by OGIT, with the reasons for this not being documented. On 15 May 1998, OASITO conducted a restricted tender to provide strategic advice, project management and technical assistance to the IT Initiative for eighteen months from July 1998 to December 1999 (Phase 3). The seventeen firms approached by OASITO were given ten business days to develop and lodge their bids based on the limited information provided in the ITSP and other publicly available information on the Initiative.

3.22 The incumbent Strategic Advisers' fee proposal provided in response to the ITSP was stated in United States dollars and reflected the fee structure existing under its previous contract. The fees proposed for the eighteen month period under consideration were A$6.5 million, some A$2 million (44 percent) higher than those proposed by the next ranked respondent. The TEC considered the next ranked respondent to represent a relatively lower cost/higher risk approach. OASITO signed a contract with the Strategic Adviser on 28 August 1998 for the provision of strategic and technical advice for the period 1 July 1998 to 31 December 1998. Fees were to be paid at the rate of US$85,000 per month (A$1.7 million per annum) for a partner-level adviser and US$65,000 per month (A$1.08 million per annum) each for two other advisers. The six-month engagement to 31 December 1998 recommended by the TEC has been extended on a number of occasions, with additional full-time advisers added, and was still in operation in July 2000.

Contract management

3.23 The management of the Strategic Adviser by OGIT and, subsequently, OASITO could have been improved to ensure the Commonwealth maximised the value obtained from the considerable expenditure incurred. In August 1997, the Strategic Adviser advised OGIT that, due to the delay by OGIT in establishing panels of legal, financial and other experts, Strategic Adviser personnel had been doing substantial drafting and other work not contemplated as part of the original engagement. This inappropriate tasking appears to have continued for some time.[84] The proposal developed by OASITO in May 1998 in support of the need to subject the Initiative's strategic, project management and technical requirements to competitive tender acknowledged that:

> *'With the experience of the first 8 months of this project it is clear that there has been overlap in some areas and no cover in others. In the case of* [the Strategic Adviser], *we have not used their resources in the most cost-effective manner. A "fixed-cost" mentality has resulted in inappropriate tasking leaving insufficient time for* [the Strategic Adviser] *to concentrate on strategic issues.'*

3.24 In April 2000, OASITO advised ANAO that, while resources were at times focussed on lower level issues than it would have liked, that focus had been necessary at that stage of implementation, '*particularly as skills transfer was not as advanced as it is today*'.

3.25 The effective tasking of advisers, particularly where there is a standard monthly payment arrangement in place, can be assisted through the use of clearly articulated deliverables. This also assists in monitoring the value-for-money obtained by the Commonwealth. Since July 1998, the contract with the Strategic Adviser has provided the Commonwealth with the capacity to advise the Strategic Adviser of specific milestones, timetables and deliverables required from time to time, and requires the Strategic Adviser to comply with any such reasonable timetables, milestones or deliverables. Specific milestones or deliverables required of the Strategic Adviser have not been articulated by OASITO.

3.26 ANAO was advised by OASITO that the Strategic Adviser undertakes tasks allocated and supervised by OASITO executives on a daily basis, and that the complex and varied nature of each outsourcing transaction dictates that varied tasks are undertaken each time. OASITO advised that the nature of the Strategic Adviser's role had made it difficult to formalise in a contract the deliverables and deadlines set on a daily basis. OASITO further advised that the very high number of external factors influencing the timing of various project milestones make it impractical to tie remuneration of advisers to those milestones.

3.27 ANAO considers that, notwithstanding the difficulty in articulating contract deliverables for a Strategic Adviser engagement, it could have been expected that there would be greater transparency regarding the identification and monitoring of the deliverables and tasking required, particularly given the important role played by the

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[84] In April 1998, internal OASITO documentation noted that, for '*various historical and resource reasons*', the Strategic Adviser's involvement in performing detailed drafting and advisory work in the implementation of tenders had been much more than originally intended.

Strategic Adviser and the scale of fees involved. In the absence of defined deliverables and milestones, the only mechanism available to the Commonwealth to confirm payment of monthly accounts rendered by the Strategic Adviser has related to the identification of actual days spent on the IT Initiative. A system to adjust invoices for known days absent was agreed between OASITO and the Strategic Adviser in 1998.

3.28 **Finding:** For sustained periods of time, particularly in the first year of the IT Initiative, the Strategic Adviser was engaged in tasking that was not commensurate with the nature of the engagement and associated fee structure. The effective tasking of advisers, especially where there is a standard monthly payment arrangement in place, can be assisted through the use of clearly articulated deliverables. Measurable deliverables required of the Strategic Adviser have not been clearly articulated and agreed in writing despite this being permitted under the current contract. OASITO advised ANAO that the nature of the Strategic Adviser's role had made it difficult to formalise in a contract deliverables and deadlines set on a daily basis. In view of the unprecedented fee structure for individual personnel in comparison to advisers previously engaged by OASITO[85], together with the duration of the assignment, ANAO considers that this matter should be addressed as a priority by OASITO.

Recommendation No. 4

3.29 ANAO *recommends* that, where appropriate, OASITO improve its management of the Strategic Adviser consultancy for the remaining duration of the IT Initiative by defining key deliverables and milestones required to be delivered by the Strategic Adviser.

3.30 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response***: **Agree with qualification.** OASITO considers that its management of the Strategic Adviser has been sound, but will investigate opportunities to establish key milestones and deliverables where appropriate.

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85 In January 1998 internal documentation, the OASITO CEO identified the Strategic Adviser as *'the most expensive advisers I have ever engaged.'*

4. Evaluation Framework

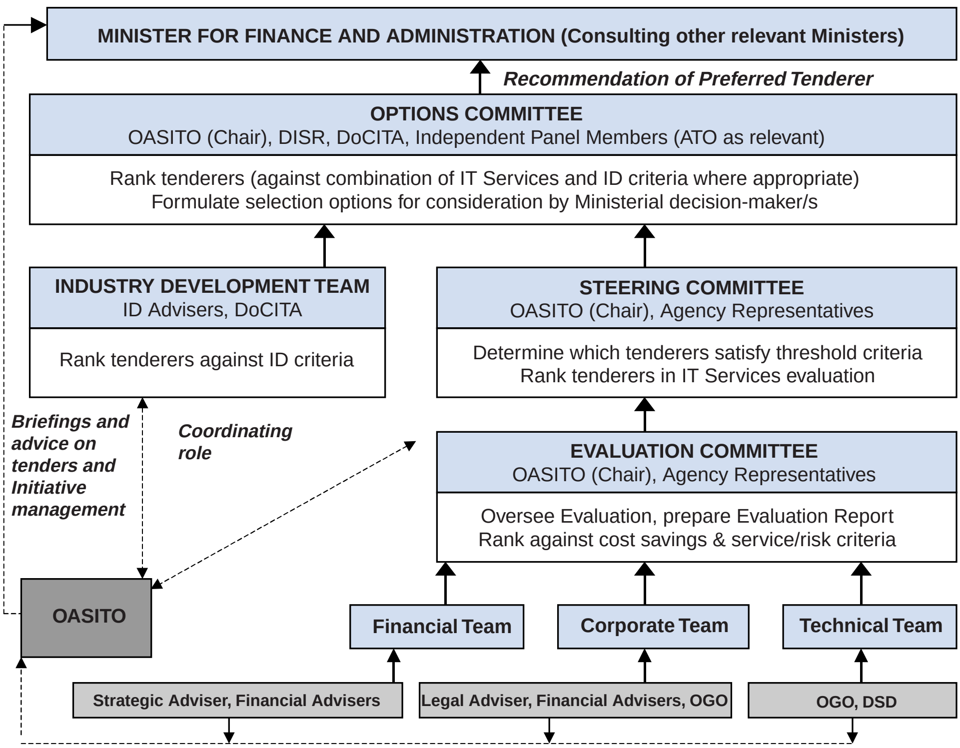
This chapter discusses the tender planning, evaluation framework and criteria established for determining the outcome in each of the tenders reviewed in this audit.

Tender evaluation structure

4.1 In each tender reviewed a comprehensive tender evaluation and reporting framework underpinned the selection of preferred tenderer by the Minister for Finance and Administration in consultation with relevant Ministers (see Figure 4.1). The IT Services and ID evaluations were conducted separately, with OASITO having an overall coordination role.

Figure 4.1

Tender evaluation structure to preferred tenderer stage



Source: Annual Report, Office of Asset Sales and IT Outsourcing, 1998-99, p.41 and ANAO analysis

4.2 An Evaluation Committee formed for each tender (chaired by OASITO and including one or more representatives from each agency) oversighted and directed the conduct of the IT services evaluation by specialist teams consisting of agency representatives. The teams were assisted by advisers engaged by OASITO. The respective Evaluation Committees drafted the IT Services Final Evaluation Report for review, comment and ultimate endorsement by a Steering Committee (also chaired by OASITO with agency representatives).

4.3 Evaluation of tenderers' ID proposals was conducted by the Industry Development Evaluation Team, consisting of advisers engaged by OASITO and representatives from the Department of Communications, Information Technology and the Arts (DoCITA).[86] The agencies to whom the IT services will be provided were not involved in the ID evaluation

4.4 The outcomes of the two evaluations were first combined when considered by the Options Committee formed for each tender, and comprising representatives from OASITO, DoCITA, Department of Industry, Science and Resources (DISR), and invited members from industry. Other than in the ATO tender, the agencies to whom the IT services were to be provided were not represented on the respective Options Committees. The Options Committee for each tender made recommendations to the Minister for Finance and Administration (and other Ministers as relevant for particular tenders) regarding the outcome of the tender process. The decision making framework also provided for OASITO to brief agency secretaries and CEOs regarding the ID offerings and the recommendations of the Options Committee.

4.5 It is good administrative practice to ensure that the decision-maker is fully informed of relevant factors prior to the execution of the procurement contract. The management structure for the final negotiations in each tender comprised OASITO in its coordination role, agencies and Commonwealth advisers. However, the provision of formal sign-offs, such as by the Probity Auditor and key advisers, did not extend past the preferred tenderer stage.

[86] In addition to participating in the ID evaluations, DoCITA is responsible for monitoring the compliance of successful tenderers with their ID commitments under the resulting Agreement. These roles were initially located within the (then) Department of Industry, Science and Tourism (DIST). Responsibility was transferred to the newly created DoCITA as part of the reorganisation resulting from the Administrative Arrangements Order 21 October 1998. At that time, DIST was reorganised into the Department of Industry, Science and Resources (DISR).

4.6 In the Cluster 3 tender, OASITO provided a written briefing to the Minister for Finance and Administration which advised that negotiations with the preferred tenderer had been successfully completed. However, updated analysis of cost savings and the extent to which the preferred tenderer satisfied the evaluation criteria was not provided. In the ATO and Group 5 tenders, a formal written briefing on the outcome of final negotiations with the preferred tenderer, including confirmation of cost savings and satisfaction of evaluation criteria, was not provided to the Minister.[87]

4.7 This contrasts with the normal practice of OASITO in undertaking trade sales where formal advice confirming the overall contractual position is provided to the decision-maker prior to the execution of the final contract. For example, in the case of the sale of DASFLEET, prior to the Minister's agreement to enter into the contract for the sale, the Business Adviser re-analysed the bids and confirmed that the preferred tenderer's offer as finally negotiated was superior and recommended that the Commonwealth accept the bid.[88] ANAO considers that, in future tender evaluations under the IT Initiative, it may be prudent for a formal mechanism to be put in place to provide confirmation to the Minister of the final contractual arrangements, and associated cost savings and ID commitments, in a structured manner.

4.8 **Finding:** The management structure for the final negotiations comprised OASITO in its coordination role, agencies and Commonwealth advisers. However, the provision of formal sign-offs, such as by the Probity Auditor and key advisers, did not extend past the preferred tenderer stage. The final briefing provided to the Minister for Finance and Administration by OASITO in support of execution of the Cluster 3 contract did not provide updated analysis of cost savings and the extent to which the preferred tenderer satisfied the evaluation criteria. In the ATO and Group 5 tenders, a formal written briefing on the outcome of final negotiations with the preferred tenderer, including confirmation of cost savings and satisfaction of evaluation criteria, was not provided to the Minister.

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[87] In the ATO tender, OASITO advised the Minister's office by email on 26 March 1999 of the contractual option ATO had elected to take up in regard to telecommunications services, and an estimate of the minimum additional costs that would result. The ATO Agreement was executed on 31 March 1999.

[88] *DASFLEET Sale*, Audit Report No.25 1998-99, p.4.

Recommendation No. 5

4.9 ANAO *recommends* that, in future IT outsourcing tenders, relevant agencies ensure that a comprehensive brief confirming the contractual arrangements negotiated with the preferred tenderer, including updated analysis of cost savings, industry development commitments and satisfaction of evaluation criteria, is provided to the relevant Ministers in support of any recommendation to enter into the final contract.

4.10 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response***: **Agree.** ANAO should acknowledge that, in the two cases in issue, the basis of the outsourcing business decision did not change between the selection of each preferred tenderer and contract signing.

Tender evaluation plans

4.11 Sound administrative practice for ensuring a fair tender process involves the establishment of, and compliance with, a comprehensive tender evaluation plan, which should be finalised before the tenders are opened.[89] Before the commencement of evaluation in each tender, tender evaluation plans or guides were jointly developed by OASITO and the relevant evaluation teams, with separate plans developed in respect of the IT Services and ID evaluations. The IT Services evaluations assessed tenderers against 'service and risk' and 'cost savings' criteria. Prior to commencement of tender evaluation, the evaluation teams identified sub-criteria to be used in assessing tenderers against the service and risk criteria set out in the RFT. Tenderers assessed as having major deficiencies against those criteria were to be excluded from further consideration.

4.12 The IT Services evaluations undertaken in the tenders reviewed did not employ evaluation methodologies that involved the use of scores or weightings. It was considered that this would promote an overly mechanistic approach. The methodology used differed between tenders, but each was based on the use of word-scales to assess tenderers against identified sub-criteria. Evaluation teams then applied professional judgement to identify an overall assessment against the criteria in the RFT.[90]

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89 *Code of Conduct and Ethics Guideline*, Office of Information Technology, New South Wales, p.6.

90 OASITO advised ANAO that these judgements were interrogated for accuracy and fairness by the Evaluation Committee as it reviewed the detailed Team Evaluation Reports and prepared the IT Services Evaluation Report.

4.13 The methodology for each tender also provided for the costing of residual risks associated with tenderers' proposals for inclusion in the overall evaluation. The costing of risks was undertaken routinely under the methodology employed in the Cluster 3 tender.[91] However, the application of the methodology was revised during the tender to give more emphasis to the role of the negotiation process in addressing and resolving issues. OASITO advised ANAO that it had become apparent during the course of the evaluation that evaluators were adopting a simplistic approach to dealing with issues by defaulting to a risk costing formula rather than addressing issues through negotiation first.

4.14 In February 1998, the (then) Legal Adviser to the Initiative advised OASITO of some specific concerns regarding the application of the evaluation methodology used in the Cluster 3 tender evaluation. The ATO and Group 5[92] tenders employed modified methodologies in which the potential for costing risks was retained but de-emphasised, and revised word-scales were applied to the evaluation of sub-criteria. Although a number of adjustments were made to tenderers' bids during those evaluations, it was unclear to ANAO from the documentary records maintained which of those adjustments were intended to address risks in tenderers' bids, and which related to errors or other identified gaps in the pricing provided. OASITO advised ANAO that, in those tenders, risk issues were either negotiated to a point where they were viewed as acceptable, or identified descriptively in the Evaluation Reports.[93]

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91 The methodology, proprietary to the evaluation consultant engaged for that tender, involved identifying instances where there was a risk or likelihood of tenderers not satisfying a sub-criterion or 'watchpoint', and costing that risk in terms of either the business impact if the risk occurred or remedies that could be provided by the tenderer.

92 In July 1998, the Group 5 Steering Committee considered the option of using a weighted scoring methodology, but viewed it as carrying a risk of mechanistic assessment without professional assessment of the overall solution, and as not assisting measurement of the costs associated with risks or shortcomings of tenders. The Steering Committee also considered that the evaluation methodology employed in the Cluster 3 tender had a number of disadvantages, such as a tendency to mechanistic reliance on the costing of removing risks at the expense of bringing to bear professional IT expertise with a broader view of the solution.

93 OASITO also advised ANAO that where issues had a direct, quantifiable cost (e.g. where the tenderer declined to accept responsibility for specific software or hardware items), those costs were included as adjustments in the financial models.

Probity plan

4.15 Generally, the appointment of a 'probity auditor' to a major outsourcing undertaking represents a means of independently monitoring the conduct of the tender process to ensure it is conducted in accordance with identified probity principles. In some transactions, a 'probity adviser' is also appointed. The 'probity adviser role' is distinguished from the 'probity audit role' in that an auditor independently reviews the conduct of the process and comments on the probity of those processes. A probity adviser, on the other hand, provides advice to those conducting the process on how to deal with probity matters, and may also be engaged to identify probity issues as they arise.[94]

4.16 In October 1997, a Probity Auditor to the IT Initiative was appointed by OGIT.[95] The engagement commenced with the Cluster 3 tender, and was to continue for the term of the Initiative. As an initial step in conducting a probity audit, a probity auditor would normally develop a probity plan. This represents good administrative practice because, by articulating the probity principles to be considered and audit work to be undertaken by the probity auditor, it enhances the ability to demonstrate the basis for assessments subsequently provided regarding the probity aspects of the tender process. A properly prepared probity plan represents a clearly articulated and objective model for the proper conduct of the tender process, against which its actual conduct may be assessed from a probity perspective. The probity plan guides the probity auditor as to the issues to be examined in determining whether there has been due and proper conduct.[96]

4.17 The October 1997 contract with the Probity Auditor set out the scope of services to be provided. These included a specific requirement to audit a number of aspects of the tender process, including the accountability and transparency of the processes adopted; management of conflicts and potential conflicts of interest; short listing and evaluation of tenderers' proposals; and selection of preferred tenderer.[97]

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[94] The South Australian Auditor-General has recommended that there be clear separation between the roles of the 'probity adviser' and 'probity auditor' to ensure the probity auditor's independence from the actual *[tender]* process, *Electricity Business Disposal Process in South Australia: Arrangements for the Probity Audit and Other Matters: Some Audit Observations*, 1999, Part 3, p.6.

[95] The Probity Auditor was engaged under a sole-sourced arrangement. A restricted competitive tender conducted by OGIT had not resulted in an appointment when conflict of interest issues could not be resolved.

[96] South Australian Auditor-General, op.cit.

[97] Other services to be provided were confirmation to the Project Directorate and relevant Steering Committee that the process relating to key Cluster Project milestones satisfied probity standards applicable to projects of this nature; and providing guidance in advance to OGIT from time to time as required in relation to the probity process.

4.18 In November 1997, shortly before responsibility for the IT Initiative was transferred to OASITO, OGIT requested that the Probity Auditor provide it with a draft probity plan. The Probity Auditor advised ANAO that a draft probity plan was provided to OASITO, however neither the Probity Auditor nor OASITO was able to provide the ANAO with a copy of the draft probity plan in the course of the audit. In commenting on the proposed audit report in August 2000, OASITO provided ANAO with a probity audit plan identified as prepared by the Probity Auditor and dated November 1997. The document provided represented the Cluster 3 Project Plan, identifying stages of the tender process, major tasks to be completed and their allotted timeframes. The major tasks identified included a number of points at which the Probity Auditor's clearance or final sign-off was to be obtained. The plan did not identify the independent audit testing that the Probity Auditor planned to undertake as the basis for providing the required clearances and sign-offs or the probity principles that would be applied by the Probity Auditor in forming those assessments.

4.19 The Probity Auditor advised ANAO that, following discussion with OASITO, it was determined that the resource requirements associated with the draft probity plan were greater than those considered appropriate for the IT Initiative. The scope of services to be provided by the Probity Auditor were subsequently revised, with the specific reference to an audit role being removed.[98] A probity plan in respect of those revised services was not provided.

4.20 OASITO advised ANAO that probity protocols, confidentiality of information and related matters were given the utmost priority and embedded in the entire documentation suite used for the various tender processes. Also, the Steering Committees and Evaluation Teams were given specific probity briefings.

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98 The revised services to be delivered included preparation and updating of probity protocols, and provision of probity briefings to the project teams and agencies; attendance at industry briefings; reviewing requests for tender, especially in respect of evaluation criteria and disclaimers; provision of ad hoc advice on issues of probity; attendance at Steering Committee and planning meetings where process is a major component; addressing conflict of interest issues; planning for parallel negotiations; reviewing final draft recommendation reports; and attendance at Steering Committee meetings approving recommendations and at Options Committee meetings.

4.21 A recent South Australian Auditor-General's report on the probity aspects of tender processes noted that:

> *…a sign-off should always be agreed in any event when a probity auditor is engaged. This assists in providing certainty as to the form and standard of assurance required from the probity auditor at the conclusion of the* [tender] *process and avoids the possibility of a misunderstanding arising between the* [Government] *and the probity auditor as to what level of assurance and 'comfort' is expected. On the assumption that a comprehensive probity plan is adopted to cover all aspects of the* [tender] *process, this sign-off should be directed at confirming that there has been compliance with the probity principles covered in such a plan.* [99]

4.22 The South Australian Auditor-General commented that the form of sign-off expected to be provided should be included in the contract for the engagement of the probity auditor. The nature of the sign-off to be provided by the Probity Auditor to the IT Initiative was not stipulated and agreed between the Commonwealth and the Probity Auditor prior to the commencement of the engagement and was not included in the contract for the engagement. The sign-off to be provided in respect of the Cluster 3 tender, the first under the engagement, was agreed with OASITO during the evaluation reporting process. A similar sign-off has been provided in respect of subsequent tenders. In each tender, the formal sign-off provided by the Probity Auditor related to the tender process up to the selection of preferred tenderer. The Probity Auditor provided no formal sign-off on the probity aspects of final negotiations with the preferred tenderer.

4.23 **Finding:** In October 1997, a Probity Auditor to the IT Initiative was appointed by OGIT. It is good practice for a probity auditor, as an initial step in undertaking their assignment, to develop a probity plan for the project. This enhances transparency of the basis for the assessments they later provide regarding the probity aspects of the tender process. The Probity Auditor advised ANAO that a draft probity plan was developed and provided to OASITO, however neither the Probity Auditor nor OASITO was able to provide the ANAO with a copy of the draft probity plan in the course of the audit. In commenting on the proposed audit report in August 2000, OASITO provided ANAO with a probity audit plan identified as prepared by the Probity Auditor and

[99] *Electricity Business Disposal Process in South Australia: Arrangements for the Probity Audit and Other Matters: Some Audit Observations*, 1999, Part 3, p.3.

dated November 1997. The document provided represented the Cluster 3 Project Plan, identifying stages of the tender process, major tasks to be completed and their allotted timeframes. The major tasks identified included a number of points at which the Probity Auditor's clearance or final sign-off was to be obtained. The plan did not identify the independent audit testing that the Probity Auditor planned to undertake as the basis for providing the required clearances and sign-offs or the probity principles that would be applied by the Probity Auditor in forming those assessments.

4.24 Following discussion with OASITO, it was determined that the resource requirements associated with the draft probity plan were greater than those considered appropriate for the IT Initiative. The scope of services to be provided by the Probity Auditor were subsequently revised. A probity plan in respect of those revised services was not provided.

4.25 The nature of the sign-off to be provided by the Probity Auditor in respect of each tender was not stipulated and agreed between the Commonwealth and the Probity Auditor prior to the commencement of the engagement or included in the contract for the engagement. The form of sign-off provided by the Probity Auditor in respect of the Cluster 3 tender, the first under the engagement, was agreed with OASITO during the evaluation reporting process. A similar sign-off has been provided in respect of subsequent tenders. The formal sign-off provided by the Probity Auditor in respect of each tender related to the tender process up to the selection of preferred tenderer. The Probity Auditor provided no formal sign-off on the probity aspects of final negotiations with the preferred tenderer.

Recommendation No. 6

4.26 ANAO *recommends* that agencies ensure that consultancy agreements developed for the provision of probity auditing services in future IT outsourcing tenders stipulate:

a) that a comprehensive probity plan is to be finalised <u>before</u> the commencement of the tender process;

b) the nature of any sign-offs and reports to be provided by the probity auditor to the decision-maker; and

c) that the scope of the probity auditor's services include provision of a formal sign-off to the decision-maker prior to the execution of the final contract.

4.27 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response***:
  - Part (a): **Agree**, providing it is acknowledged that the probity framework was developed for Cluster 3 and incorporated in the Cluster 3 Project Plan prior to release of the RFT. The probity framework was appropriate and has been applied in all tender processes under the Initiative. The activities identified in the project plan are reflected in the Probity Auditor's Contract Schedule of Services.
  - Part (b): **Agree**, providing it is acknowledged that the decision maker was advised of probity auditor Sign Offs at relevant project milestones and that the signoffs agreed with the probity auditor were in an acceptable form.
  - Part (c): **Agree.**

4.28 ***ANAO comment:*** The recommendation is directed at supporting the improved application of good practice in future tenders. The probity plan identified by OASITO as having been provided to it by the Probity Auditor did not identify the independent audit testing that the Probity Auditor planned to undertake as the basis for providing the required clearances and sign-offs or the probity principles that would be applied by the Probity Auditor in forming those assessments (refer discussion at paragraphs 4.15 to 4.20). The sign-off provided should be directed at confirming that there has been compliance with the probity principles covered in the comprehensive probity plan provided by the probity auditor. Agreeing the sign-off that will be provided at the time a probity auditor is engaged would assist in providing greater certainty as to the form and standard of assurance required from the probity auditor at the conclusion of the process (refer discussion at paragraphs 4.21 to 4.22).

Evaluation criteria

4.29 The evaluation criteria to be applied in tenders under the IT Initiative have changed over the course of the Initiative. The Commonwealth Procurement Guidelines (CPG) state that the evaluation criteria for any particular procurement should clearly identify the relative importance of all relevant factors and provide a sound basis for a procurement decision.[100] It is sound administrative practice for that selection basis to be determined before the tender documentation is issued, and for it to be communicated to potential tenderers through the tender documentation, so they have an informed basis on which to decide whether to tender, and the nature of tender to prepare.

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[100] CPG, March 1998, p.8.

4.30 The evaluation criteria to be applied in determining the outcome of the Cluster 3, DEETYA/EN, ATO and Group 5 tenders were identified in the RFTs provided to potential tenderers. The evaluation criteria and relative priorities set out in each RFT established a decision-tree as the basis for determining the outcome of the tender (as seen in Figure 4.2), and were grouped into three categories:

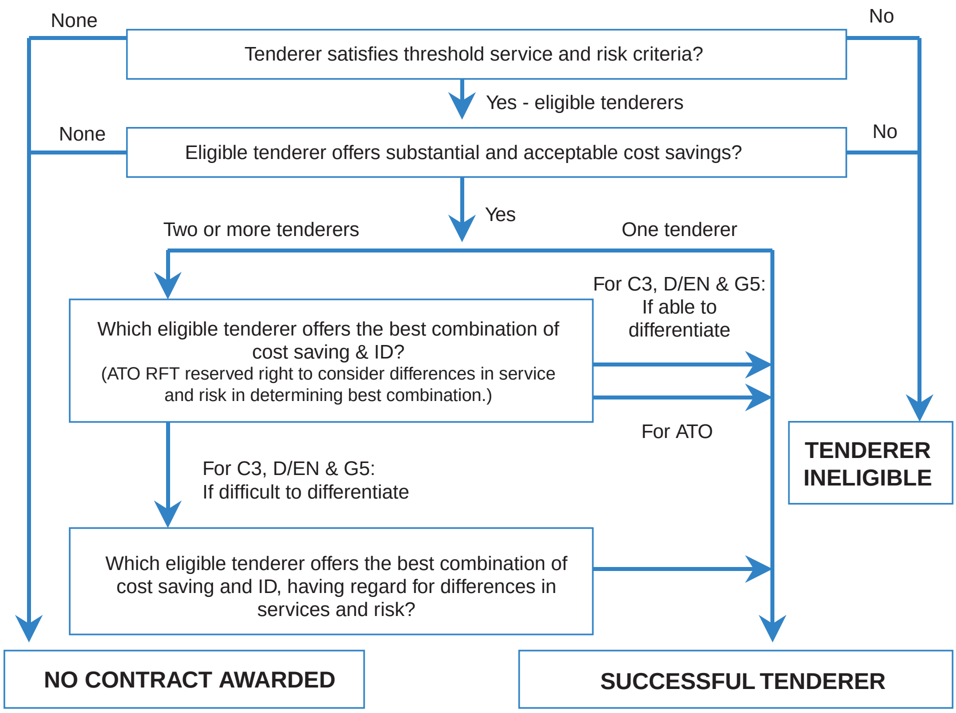
a) cost savings;

b) industry development (ID); and

c) "service and risk" in relation to delivery of the services.[101]

Figure 4.2

Overview of evaluation criteria—Cluster 3, DEETYA/EN, ATO and Group 5



Source: ANAO analysis of Cluster 3, DEETYA/EN, ATO and Group 5 RFTs

4.31 Cost savings and ID were identified as the Commonwealth's primary objectives in each tender. In each case, the tender documents established two preconditions to the awarding of a contract. The service and risk criteria formed threshold criteria that had to be satisfied before a tenderer was eligible to be considered in terms of cost savings and ID and, potentially, be selected as preferred tenderer (eligible tenderers).

101 This comprises criteria relating to corporate capability; commitment to service and overall risk; and technical solution.

4.32 Each RFT also explicitly stated that '*a<u>chievement of substantial cost savings is a precondition to the award of a contract</u>*.' It was stipulated that the Commonwealth would not award a contract unless the Commonwealth was satisfied that the preferred tenderer would deliver a substantial and acceptable level of cost savings based on an assessment against the criteria relating to cost savings specified in the RFT. This assessment was to include evaluation of the extent to which tenderers' pricing and pricing structure satisfied each of five identified criteria.[102] Where more than one tenderer was assessed as offering substantial and acceptable cost savings, the Commonwealth would determine the preferred tenderer on the basis of the best combination of industry development and cost savings.

Value-for-money

4.33 The CPG stipulate that value-for-money is the essential test against which agencies must justify any procurement outcome. It is not an attribute or criterion in itself, but is a basis for comparing alternative solutions. It is through the consideration of both financial and non-financial benefits and risks that the value-for-money offered by tenderers can be best assessed.

4.34 The essential elements of a value-for-money assessment—cost, service and risk—were incorporated in the evaluation criteria set out in each RFT. However, under the Cluster 3, DEETYA/EN and Group 5 RFTs, the Commonwealth could only take account of differences in the service and risk aspects of eligible tenderers in determining the preferred tenderer where two or more eligible tenderers were difficult to differentiate in terms of the best combination of cost savings and ID. In July 1998, the Strategic Adviser recommended to OASITO that the criteria be changed to provide that the Commonwealth reserved the right to take account of service and risk considerations in determining the best combination of industry development and cost savings.[103] The revised provision was included in the ATO RFT. ANAO considers the revised provision more

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[102] The criteria were the extent to which a tender's pricing and pricing structure would: 1) enable agencies to maximise savings compared with the cost of continuing to provide the services themselves and, in two of the tenders, the cost of other tenderers; 2) ensure that prices for the services remained market competitive throughout the term; 3) provide predictable charges with no unanticipated price increases over time; 4) provide 'gain-sharing' arrangements such that the Commonwealth would receive substantial financial benefits from productivity gains and business process improvement; and 5) be flexible enough to adapt to agencies' changing technology and business needs, including changes arising out of Government administration arrangements and agency restructuring, strategic planning and re-engineering projects.

[103] The Strategic Adviser advised OASITO that the original clause had been designed to '*…limit the agencies' ability to interfere with the selection process by imposing their preferences based on 'service and risk' considerations.'*

fully supported the application of overall value-for-money considerations in a tender evaluation.

4.35 In March 1999, OASITO advised the Minister for Finance and Administration of the need to revise the evaluation criteria for future tenders under the IT Initiative, starting with the Group 8 tender. The revised criteria were to be 'value-for-money' (in place of cost savings) and industry development (ID).[104] OASITO noted that this approach would align the IT outsourcing projects to the intent of the Prime Minister's December 1998 letter and made the approach consistent with the CPG. OASITO advised ANAO that the 'substantial savings' precondition had been omitted from all RFTs published after the Prime Minister's letter. The RFTs for the tenders considered in this audit were all released prior to the Prime Minister's letter.

4.36 **Finding:** Tender objectives were addressed during the Cluster 3, DEETYA/EN, ATO and Group 5 tender evaluation processes by predetermined evaluation criteria and a structured approach to ranking against individual criteria. Cost savings and ID were identified as the Commonwealth's primary objectives. The tender documents established two preconditions to the awarding of a contract. The service and risk criteria formed threshold criteria that had to be satisfied before a tenderer was eligible to be considered against the cost savings and industry development criteria, and therefore to, potentially, be selected as preferred tenderer. Each RFT also explicitly stated that '*Achievement of substantial cost savings is a precondition to the award of a contract*.'

Evaluation of cost savings and industry development

4.37 In the tenders reviewed in this audit, the purpose of the financial evaluation was to provide the relevant Ministers with the information necessary to determine whether the threshold requirement for substantial savings had been satisfied and, if so, to rank tenderers in terms of the cost savings evaluation criteria set out in the respective RFTs.

[104] In recommending the revision, OASITO noted that: *The previous evaluation criteria concentrated heavily on cost savings to the detriment of other value-for-money considerations.* OASITO went on to report that: *From an agency perspective, the evaluation was centred on the cost saving element with little regard for other value offerings and other potential benefits.* ANAO notes that, in commenting on the draft Cluster 3 RFT in September 1997, the (then) Department of Administrative Services (DAS) queried whether, rather than 'substantial overall cost savings', the principal objective of the tender should be identified as value-for-money which would take into account service extensions and improvement etc. ANAO considers that articulating the criteria in this form in the first instance may have assisted in obviating the potential for behaviour of the type identified by OASITO. Articulating the criteria in the form recommended by DAS would have been consistent with the CPG requirement regarding value-for-money existing at the time.

4.38 A common means used by both private and public sector entities to analyse capital investment decisions is discounted cash flow (DCF) analysis. The DCF technique of net present value (NPV) provides a common measurement point where financial evaluations seek to compare unequal cash flows over a number of years. It involves consideration of the following issues:

- Discount rate: which accounts for the opportunity cost of capital and the length of time before the cash flows are received/paid;
- Incremental cash flows: under a DCF, incremental cash flows for a proposal should be evaluated by considering all of the cash inflows and outflows induced by the investment decision in question.[105] For example, because the costs associated with voluntary redundancy payments to existing agency personnel arise only as a consequence of a decision to outsource the provision of the services, they should only be included as a cost associated with the outsourcing option; and
- Residual value of assets: which is included, generally at fair market value (FMV) or deprival value, as it represents a component of value generated by the identified cash outflows that lies outside the stipulated evaluation period. The inclusion of end-of-period asset adjustments enables the analysis to make valid comparisons between, say, an agency owning an asset compared to an ESP leasing an asset to the agency.[106]

4.39 Given the five year time period used for tender evaluations under the IT Initiative, a properly structured analysis involving DCF would provide the decision-maker with the necessary comparative information to make a considered decision on whether to proceed to outsourcing under a particular tender in the tender field, and be able to compare the tender costs with baseline in-house costs. Under this approach, if the present value of cash flows involved in outsourcing is less than the present value of agency provision of IT services, then outsourcing would have a positive NPV to the Commonwealth.

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105 *Capital Investment & Financial Decisions,* Fourth Edition, Haim Levy and Marshall Sarnat, 1990, p. 104.

106 An alternative presentation of this analysis is the use of the equivalent annual charge approach in comparing purchase versus leasing of assets with unequal lives. This approach involves discounting the expected cash flows, including residual value, to a present value, and then determining their equivalent annual charge over the asset's life.

4.40 Ideally, the analysis would fully capture the commercial risk exposures that arise should the contract be terminated during the contract period (for breach or convenience); as well as the implications associated with scenarios that may arise in the contractual out-years—namely, whether agencies continue with the existing vendor, move to a new supplier or bring the services back in-house. It is preferable for the quantification of the commercial risks from events that may occur during the period of the contract and upon its expiration to be explicitly incorporated in the financial analysis. However, in the event that this proves difficult, it would be advisable to present a range of possible outcomes reflecting various assumptions to the decision-maker to inform his/her decision.

OASITO financial evaluation framework

4.41 The financial evaluation conducted in each tender reviewed by ANAO was based upon three models developed by OASITO in consultation with its Strategic Adviser and Financial Advisers, and approved by DOFA, to support the whole-of-Government framework of the IT Initiative. The three models were the:

- Cost Model—a template provided to agencies for the identification of the baseline 'business-as-usual' costs of continuing to provide the in-scope services in-house. The methodology required that, to the extent the in-scope service requirements (as defined by agencies in the tender documentation) varied from existing internal practices or volumes as covered by existing funding, then appropriate adjustments were to be made to future cost projections of continued in-house provision;
- Price Model—provided to tenderers to prepare the detailed pricing required by platform and agency; and
- Savings Model—used to compare agency baseline costs with the prices proposed by each tenderer, and to compare tenderers' proposals with each other. This included sensitivity analysis of the effect of volume and inflation adjustments on tenderers' bids. The model included adjustments for new costs incurred by agencies as a consequence of outsourcing (eg. voluntary redundancy payments and contract management costs), and reduced costs arising from the decision to outsource (eg. payments received from tenderers for the purchase of agency assets and the value of agency accommodation able to be released for other uses). The result of this comparison was a model of the projected cash savings (or premium) provided by each tenderer for each year and line of service, by agency and for the group overall.

4.42 After the savings in agency cash outlays attributable to each tenderer had been calculated, notional competitive neutrality (CN) adjustments were added to the agency cost baselines. These adjustments related to costs faced by private sector providers (and therefore reflected in their prices) that public sector agencies were not subject to, such as a requirement to earn a commercial rate of return on capital and the payment of wholesale sales tax[107] and payroll tax, and were then reported, together with the financial savings identified, as notional post-CN savings. In February 2000, OASITO advised ANAO that the CN adjustments were calculated by the Financial Evaluation Team in each tender. However, ANAO notes that the Group 5 IT Services Final Evaluation Report stated that, in accordance with OASITO guidelines, adjustments for CN are an OASITO responsibility. The Group 5 Financial Evaluation Team reported that it had 'noted' the CN adjustments proposed by OASITO.

Presentation of net present values

4.43 In December 1997, DOFA advised OASITO that, for the purposes of the comparative financial evaluation of tenders under the IT Initiative, a real discount rate of 8 percent should be used. The basis for this suggestion was that 8 percent is a well established benchmark discount rate in the budget-dependent sector and is reflective of the Capital Asset Pricing Model (CAPM) framework as it relates to general government activity and to rates of return in the Australian corporate sector. However, DOFA also recommended that OASITO apply sensitivity testing using discount rates of 10 percent and the current Treasury long term bond rate.

4.44 In each tender reviewed, the projected cash savings were analysed in NPV terms applying the range of discount rates suggested by DOFA. However, OASITO advised ANAO that the financial evaluation methodology applied in each case was a cash based methodology, not a

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[107] Under the *Sales Tax (Exemptions and Classifications) Act 1992* , government bodies are exempt from sales tax where they buy goods for their own use. That exemption can apply to goods bought or leased by an IT outsourced provider only where an eligible long-term lease exists with the government body. In each of the tenders reviewed, the evaluation was conducted on the basis that the successful tenderer would not be subject to sales tax in respect of dedicated equipment used in the delivery of the services (primarily desktop equipment). Tenderers were asked to provide pricing both inclusive and exclusive of sales tax, with the exclusive pricing used to calculate projected savings. Because an ATO ruling on the applicability of sales tax exemption can only be sought once a Services Agreement is in place, this pricing was contingent upon such exemption being subsequently obtained by the successful tenderer. In support of any application to the ATO for an exemption ruling, the successful tenderer requires a Statement of Intent from the government body stating its intent to use the equipment in exempt circumstances in relation to an eligible long-term lease.

DCF methodology. The financial evaluation methodology adopted in the Cluster 3, ATO and Group 5 tender evaluations did not capture end-of-evaluation-period residual values of agency assets. This issue is discussed further at Chapter 7.

4.45 OASITO advised ANAO that the methodology applied was for the primary savings to be calculated on a cash basis, with NPV analysis only applied as a sensitivity to test whether tenderer rankings changed in NPV terms using different discount rates. OASITO further advised that:

> *The analysis presented to the decision maker was the result of an undiscounted cash analysis of tenderer proposals against the cost baseline. The common measurement point is cash. Figures presented as NPV were the results of sensitivity analysis. It should be noted that, consistent with the Commonwealth budgetary processes, the savings estimates developed as part of the initial OGIT/DOF scoping study, the budget reductions taken from agencies at the commencement of the Initiative and the publicly announced savings figures for each of the tender processes reviewed in this audit have all been calculated in actual (undiscounted) dollars over the relevant evaluation periods.*

4.46 However, ANAO notes that there appears to have been some confusion as to whether evaluation conclusions were based upon undiscounted or NPV savings estimates. The Cluster 3 Evaluation Committee and ATO Financial Evaluation Team both reported that the ranking of tenderers in respect of the cost savings criteria was based on the tenderers' *respective NPV savings*. There has also been inconsistency in the presentation of undiscounted and NPV savings estimates in the tender evaluations reviewed. All savings figures presented in the Cluster 3 IT Services Final Evaluation Report and briefings to the Minister for Finance and Administration were presented in both undiscounted and NPV terms, using an 8 percent discount rate.

4.47 The ATO Financial Evaluation Report identified savings in undiscounted and NPV terms, using the range of discount rates suggested by DOFA. But the NPV savings presented in the Executive Summary of the ATO IT&T Services Final Evaluation Report used an 8 percent discount rate only. The brief by OASITO to the Minister for Finance and Administration covering the ATO Options Committee preferred tenderer recommendation specified undiscounted savings figures, but identified an 8 percent discount rate in the presentation of those figures. This somewhat misleadingly suggested that at least some of the figures presented were in NPV terms. In contrast, in the Group 5 tender, the Minister was provided with no NPV analysis of the projected savings.

The Group 5 IT Services Evaluation Report noted that an analysis had been performed on NPV prices which showed no difference in the ranking of tenderers on price.

4.48 Given the five year evaluation period, it is appropriate for savings estimates to also be presented in accordance with the DCF technique of NPV as this provides a common basis for comparison of the unequal cash flows and asset lives incorporated in the agency cost baselines and tenderers' prices. Therefore, ANAO considers that a consistent approach to the presentation of undiscounted and discounted financial evaluation outcomes would enhance the clarity and completeness of the information provided to the decision-maker in future tenders under the IT Initiative.

4.49 Given the inconsistent approach to the presentation of NPV savings in the tenders reviewed, ANAO has applied a discount rate of 8 percent in the presentation of net present values. In April 2000, OASITO advised ANAO that in July 1999 it had received advice from an accounting firm recommending that cash flows other than end-of-term asset realisations be discounted using a risk free real rate of return. OASITO advised that the April 2000 rate was approximately 3.16 percent, and that such a rate had been used for discounting purposes in subsequent tender processes. OASITO considered that use by ANAO of a single discount rate of 8 percent for presentation of NPV savings from the tender evaluations was inappropriate, and would produce distorted savings results.

4.50 ANAO notes that 8 percent was the discount rate recommended by DOFA for use in the comparative financial evaluation of tenders under the IT Initiative, and was the rate most commonly and prominently applied wherever the Minister was provided with NPV savings estimates in the tenders reviewed. At no time during the Cluster 3, ATO or Group 5 tenders was the Minister provided with NPV savings estimates based upon a 3.16 percent discount rate. Therefore, presentation of NPV savings using that rate would not be representative of the information on which the tender outcomes were determined.

4.51 **Finding:** The Cluster 3 Evaluation Committee and the ATO Financial Evaluation Team both reported that the ranking of tenderers in respect of the cost savings criteria was based on tenderers' *respective NPV savings*. In contrast, in the Group 5 tender, the Minister was not provided with NPV analysis of the projected savings. ANAO considers that a consistent approach to the presentation of undiscounted and discounted financial evaluation outcomes in future tenders under the IT Initiative would enhance the clarity and completeness of the information provided to the decision-maker.

Recommendation No. 7

4.52 ANAO *recommends* that, when conducting financial evaluations involving uneven cash flows over time, relevant agencies account for the time value of money in net present value terms, consistently applied in the evaluation outcomes presented to the decision-maker.

4.53 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response***: **Agree with qualification.** Financial evaluations calculated the time value of money using a variety of discount rates to determine the sensitivity of tender evaluation decisions to inflation and other factors. OASITO is prepared to expand the discussion of NPV values in the formal reporting processes, but considers that the methodology adopted in the tender processes in question was appropriate.

Industry development evaluation framework

4.54 Each RFT stipulated that the highest-rated ID proposal would be the proposal that, in the Commonwealth's opinion, offered the most credible and sustainable ID, and was most likely to achieve the Government's identified objectives and priorities. The credibility and sustainability of tenderers' ID proposals was assessed against the ID objectives, priorities and desired outcomes through a series of quantitative and qualitative criteria and using a combination of work and numeric rating scales. No relative priorities or minimum requirements were stipulated in respect of those criteria. This was considered a function of the competitive environment of each tender.

4.55 A threshold issue for the ID evaluation was that the Commonwealth would only take into account commitments that were specifically related to the IT services project being tendered and could not relate to tenderers' existing 'business as usual' or ID activities. The evaluation also assessed the relative strength of the financial 'sanctions' proposed by tenderers' for non-performance of their ID commitments.[108]

[108] In each case, the RFT stipulated that tenderers would be required to propose sanctions that clearly demonstrated that non-performance of their ID proposals would be financially disadvantageous to their organisation. At a minimum, prospective tenderers would be asked to propose specific dollar amounts to be payable to the Commonwealth in the event that the commitments were not met within the time frames specified in their proposal.

Combined cost savings and industry development (ID) evaluation

4.56 It was the role of the Options Committee formed for each tender to consider the findings of the IT services and ID evaluation teams, and to then formulate selection options for consideration by the Ministerial decision-maker/s. Where appropriate under the terms of the RFT, those options were required to include consideration of the tenderer that offered the <u>best combination of cost savings and ID</u>. In none of the tenders reviewed did the tender evaluation planning articulate the approach that would be used to determine that combined assessment of tenderers.

4.57 Of the three completed tenders reviewed, Group 5 was the only one in which the tenderer assessed as offering the most cost savings was not also ranked highest in the ID evaluation. However, in that tender, the other two shortlisted tenderers were not assessed as offering any savings. Therefore, in none of the tenders reviewed by ANAO was there a need to form combined cost savings/ID rankings in order to determine the preferred tenderer.[109] However, that outcome could not be foreseen at the commencement of those tenders, and, therefore, cannot be relied upon occurring in future tenders.

4.58 It is recognised that a degree of professional judgement will be required in determining the tenderer that offers the best combination of factors such as cost savings (or value-for-money) in the delivery of IT services, and unrelated ID commitments. However, sound administrative practice involves determining the basis on which the winning tenderer in a competitive tender process will be selected before the tender documentation is issued, and devising evaluation criteria that will provide a methodology for distinguishing between tenderers on that basis. No methodology was determined in the tenders reviewed for forming tenderers' combined rating against the tenders' two primary objectives, cost savings and ID.

4.59 The absence of an articulated methodology does not necessarily preclude a decision-maker from dealing fairly with all tenderers in determining the outcome of a tender. However, the advantage of following good administrative practice in conducting a tender evaluation

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109 In Cluster 3, the preferred tenderer was assessed as offering the highest level of savings (44 percent greater than next ranked) and was ranked first against the ID criteria. In Group 5, the preferred tenderer was the only tenderer assessed as offering savings, and was assessed as adequately meeting the Government's ID objectives (ranked equal second in ID evaluation). In the ATO tender, the preferred tenderer was the only tender assessed as offering savings and was ranked first against ID.

is efficiency, together with an enhanced ability to show how the process was conducted so as to defend the decision made. Transparency and accountability of decision making could be enhanced in future IT outsourcing tenders by incorporating into the tender planning process consideration of the means by which tenderers will be ranked in terms of the best combination of value for money/cost savings and industry development criteria.

4.60 **Finding:** The evaluation criteria set out in the respective RFTs for the tenders reviewed provided that, in specified circumstances, the preferred tenderer would be based on an assessment of the tenderer that provided the best combination of cost savings and industry development. In none of the tenders reviewed did the tender evaluation planning articulate the approach that would used to determine that combined assessment. Transparency and accountability of decision making could be enhanced in future IT outsourcing tenders by incorporating into the tender planning process consideration of the means by which tenderers will be ranked in terms of the best combination of value for money/cost savings and industry development criteria.

Recommendation No. 8

4.61 ANAO *recommends* that, in future IT outsourcing tenders, relevant agencies enhance transparency and accountability of decision making in the tender process by incorporating into the evaluation planning process consideration of the means by which tenderers will be ranked in terms of the best combination of value for money/cost savings and industry development criteria.

4.62 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response:*** **Disagree.** The evaluation planning process is clear and takes full account of Government policy objectives.

4.63 ***ANAO comment:*** A tender evaluation is one part of a tender process and must be conducted in accordance with that process, especially where the process to be followed has been notified to the tenderers. The evaluation criteria set out in the respective RFTs for the tenders reviewed provided that, in specified circumstances, the preferred tenderer would be based on an assessment of the tenderer that provided the best combination of cost savings and industry development. In none of the tenders reviewed did the tender evaluation planning articulate the approach that would be used to determine that combined assessment.

4.64 It is open to the Commonwealth to select the winning tenderer on any basis it chooses, provided that the Commonwealth deals <u>fairly</u> with all tenderers in conducting the process. Accordingly, the recommendation is directed at supporting the establishment of an appropriate framework for determining the basis on which the successful tenderer would be selected before the tender documentation is issued, and for devising suitable evaluation criteria that would provide a sound methodology for distinguishing between tenderers on that basis. It is acknowledged good administrative practice for the evaluators to decide how the criteria would be applied before they consider the tenders. In this case, it would involve incorporating into the evaluation planning process consideration of the means by which tenderers would be ranked in terms of the best combination of value for money/cost savings and industry development criteria.

5. Tender Evaluation

This chapter discusses the evaluations undertaken in respect of the four RFTs considered in this audit, the industry development outcomes reported and the reporting of tender evaluation outcomes against the published evaluation criteria.

Introduction

5.1 The evaluation processes undertaken for the Cluster 3, DEETYA/EN, ATO and Group 5 tenders consisted of two principal phases. Key stages in the tenders reviewed in this audit are set out in Figure 5.1.

Figure 5.1

Key stages in Cluster 3, DEETYA/EN, ATO and Group 5 tenders

Key Stage	*Cluster 3*	*DEETYA/EN*	*Group 5*	*ATO*
Advance Notice to release RFT	29/9/97*	30/1/98	13/4/98	30/6/98
RFT released	4/11/97	23/2/98	1/6/98	7/8/98
Tenders closed	2/12/97	14/4/98	6/8/98	23/10/98
Tenderers	4	1	8	3
Exclusion of ineligible tenderers	20/1/98	26/5/98	30/9/98	n/a[110]
Tenderers in parallel negotiations	3	1	3	2
Tender discontinued	n/a	11/6/98	n/a	n/a
Revised RFT released	n/a	n/a	11/2/99	n/a
Final Evaluation Reports	24/2/98	n/a	22/3/99	9/3/99
Preferred Tenderer endorsed	5/3/98	n/a	25/3/99	12/3/99
Endorsement of final contract briefing	25/3/98	n/a	n/a	n/a
Contract executed	31/3/98	n/a	14/4/99	31/3/99
Handover of services	1/7/98	n/a	1/7/99	24/6/99
* Draft RFT released				

Source: ANAO analysis of OASTIO records and tender evaluation reports

5.2 The Initial Evaluation phase incorporated a formal question and answer process to eliminate, as far as practicable, any inconsistencies, ambiguities or uncertainties in each offering. Based primarily upon an assessment of whether tenderers were considered likely to satisfy threshold service and risk criteria, a determination was made as to whether their participation in the tender process should be continued.

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110 One tender received was a non-compliant partial offering limited to components of the telecommunications services. The Final Evaluation Report stated that it was not possible for the Commonwealth to fully evaluate the partial offering independently from the integrated IT&T service offerings put forward by the other tenderers, and that the tenderer was therefore advised that the Commonwealth would not further consider its offering.

5.3 The Final Evaluation phase incorporated detailed clarification of tenders, and parallel tender negotiations. In each tender, this phase involved multiple re-pricing by tenderers and adjustments to both agency cost baselines and tenderers' bids. The contractual terms and conditions each tenderer would accept were also negotiated. Tenderers were ranked in the IT services evaluation based upon assessment of their final proposals against the 'service and risk' and 'cost savings' evaluation criteria. Rankings in the ID evaluation were based upon proposed ID commitments and associated 'sanctions'. The findings of each evaluation were referred to the Options Committee formed for each tender for formulation of selection options to relevant Ministers.

Service requirements and costing

5.4 Cost savings was a primary objective of the Cluster 3, DEETYA/EN, ATO and Group 5 tenders. An essential element in accurately projecting the savings offered by tenderers is the construction of agency cost baselines that, to the extent possible in a five-year projection, accurately reflect the costs agencies would incur in delivering internally the services being sought from tenderers. Such long-term projections are inherently difficult and complex, particularly in a rapidly changing environment such as IT&T. The understatement or overstatement of agency costs, or misalignment in the nature, level or quality of service reflected in agency cost baselines and tenderers' bids, have the capacity to distort the outcome of the financial evaluation. As with any projection, however, the savings identified in the tender evaluations reviewed were estimates modelled on the information available <u>at the time</u>.

5.5 Each agency was responsible for framing its requirements for presentation to potential tenderers through the RFT, and for constructing its projected baseline costs using the cost model provided by OASITO. The service levels required by agencies have a direct relationship with the costs involved in delivering those services. Higher service levels will often result in higher costs due to the requirement to invest in additional infrastructure and personnel.

5.6 Agencies made various efforts to define existing and required service standards to support the preparation of the relevant RFT and cost baselines. Financial Advisers engaged by OASITO reconciled the completed agency cost models with the information and service requirements set out in the RFT. The documentation was reviewed from the perspective of consistency, reasonableness and accuracy, but agencies remained responsible for determining their cost baselines. In conducting each reconciliation, the Financial Advisers noted issues for review as appropriate. A number of agencies also engaged external or internal parties to review their cost baselines.

5.7 During each tender, where the financial effect of identified misalignments between agency cost baselines and RFT requirements was quantified and substantiated, adjustments were made to either agency cost baselines or tenderers' prices by agreement between OASITO and the agencies concerned. Despite those processes, OASITO expressed the view over the course of the tenders reviewed, particularly for Group 5, that differences between the requirements specified in the RFTs and the service levels previously achieved internally by agencies (as represented in their baseline costs) meant that the financial comparison was not on a like for like basis, and could result in an understatement of the savings available from outsourcing.

5.8 The Group 5 tender evaluation, finalised in March 1999, identified small financial savings over the five year term for the Group overall. However, for two of the Group agencies, DoCITA and DoTRS, the costs under outsourcing were assessed as representing a premium over the agency cost baseline. OASITO advised ANAO that the savings outcomes in that tender did not purport to take account of differences in service quality between the cost baselines of some Group agencies and the RFT requirements, which it considered to have heavily influenced the reported outcome by understating the available savings.

5.9 Group agencies disagreed with those concerns. The Group 5 CMO advised ANAO that the recollection of Group 5 agencies was that adjustments were made during the tender evaluation to the relevant agency baseline costs to better align them with the services sought in the RFT. The Group agencies considered that this should have largely or wholly negated cost differences due to differences in service standards.[111]

5.10 There were a number of additional reviews of Group 5 agency baselines during the tender evaluation process,[112] with the final review completed just prior to the conclusion of the evaluation. OASITO advised ANAO that the adjustments made as a result of those reviews did not resolve its concerns regarding alignment with RFT requirements and the comparability of internal cost projections and tendered prices.

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111 The Group 5 IT Services Final Evaluation Report noted that: *Considerable efforts have been made, with the assistance of OASITO, to ensure that as far as possible there is comparability between the services provided by tenderers and those covered in agency cost baseline models. The quality and nature of the services are not always identical between the services provided by the tenderers and those in the agency cost baseline models.*

112 The first began in September 1998, approximately one month after the agencies provided sign-off on the final version of the Cost Model. Evaluation of tenders (received 6 August 1998) had commenced following that sign-off.

5.11 The Group 5 agencies advised ANAO that, in the absence of an ability to provide a basis for those concerns, and given that the agencies had cooperated in good faith with OASITO to review baselines and service levels and make financial adjustments to compensate for mismatches, the Group considered OASITO's claim to be unbalanced.

5.12 Although other potential misalignments were identified in various reviews, they were unable to be quantified and/or fully substantiated.[113] This was partly due to the nature of available documentation. An external consultant engaged by OASITO reported that the Group 5 agencies did not have in place systematic reporting and measuring tools to measure existing service delivery and substantiate whether they were meeting the service levels in the RFT. However, a number of Group 5 agencies did not agree that they could not adequately substantiate their historic service delivery. An independent consultant engaged by DoCITA to review that agency's baseline in the light of OASITO's concerns concluded that the information was available to support service levels and the level of work identified in the RFT.[114]

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[113] OASITO advised ANAO that a very conservative approach had been adopted in the preparation of the cost baselines and evaluation of offers to avoid any overestimation of savings, and that many potential financial adjustments were set aside as a result of the inability to quantify adjustments with certainty. In contrast, the Group 5 CMO advised ANAO that the Group agencies did not see such evidence during the preparation of their baselines and the evaluation of tenders. The Group advised that evaluators, with the active involvement or initiative of OASITO, pursued all identified issues that may have impacted the savings estimate in either direction in order to achieve a reliable estimate.

[114] Although acknowledging that the supporting material was by necessity anecdotal, and that there was an underlying risk of under- and over-statement of workload or performance, the consultant noted that DoCITA attempted to be conservative in setting performance indicators to address this risk. The consultant was, in general, confident about the reasonableness of those indicators. However, the consultant was less confident about the identification of in-scope activity (which was reflected in the cost baseline) and out-of-scope activity (which was not). The consultant was concerned that some personnel costs that DoCITA had assessed as out-of-scope were more appropriately in-scope, which would have the effect of understating the agency baseline costs. The Group 5 CMO advised ANAO that, although the Group has not maintained its own independent records of the financial evaluation, the evaluation team members recall that a substantial adjustment to the DoCITA baseline (several FTE) was made on the presumption that some in-scope staff costs may not have been included. DTRS, the other agency for whom savings were not apparent, reported that it conducted a series of surveys of its in-house IT performance over defined periods, and also looked at historical data and systems logs where available. From this combined information it analysed and extrapolated results to develop its annual service level requirements. The Department reported that there were only a couple of service levels relating to Help Desk services where it had no technology to measure its existing performance and had, therefore, based the service level in the RFT on anecdotal evidence.

5.13 The external consultant engaged by OASITO to conduct the final review of Group 5 baselines identified a number of areas in which the construction of agency cost baselines could be improved in subsequent tenders, including the use of independent consultants to develop the cost baseline or, at a minimum, staff from outside the immediate area under consideration; review of baselines by independent IT and financial management specialists; and reviewing agency service levels against industry benchmarks.

5.14 Addressing these issues in the tenders reviewed was resource-intensive for all parties and contributed to delays in the tender process. This experience highlighted that the efficiency and effectiveness of IT outsourcing tender processes in which cost savings are identified as a primary objective and evaluation criterion will be enhanced to the extent that, in preparing for the tender process, agencies establish reliable and independently verifiable information about the service levels achieved under the existing internal service delivery models, their comparability with industry standards, and the resources applied in providing those services.

5.15 The August 2000 DOFA whole-of-government response to the proposed audit report noted that:

> *When constructing five, six and seven year cost projections, agencies are required to estimate how internal costs will perform over those periods with, in some cases, very limited internal historical data as a guide. OASITO assists by providing industry benchmarks and price/ performance trend data where this is available. It is not surprising that differences of view on these matters may emerge and be the subject of debate during the course of the tender process. This should be acknowledged as an important contributor to a robust evaluation process.*

5.16 **Finding:** Over the course of the tenders reviewed, particularly Group 5, OASITO expressed the view that differences between the requirements specified in the RFTs and the service levels previously achieved internally by agencies (as represented in their baseline costs) meant that the financial comparison was not on a like for like basis, and may be resulting in an understatement of the savings available from outsourcing. There was disagreement by agencies regarding the validity of those concerns, particularly given the large number of reviews that were undertaken of the agency baselines during the tender evaluation process.

5.17 Where the financial effect of identified misalignments between agency cost baselines and RFT requirements was quantified and substantiated, adjustments were made to either agency baselines or tenderers' prices by agreement between OASITO and the agencies concerned. Although other potential misalignments were identified in various reviews, they were unable to be quantified and/or fully substantiated. Addressing these issues in the tenders reviewed was resource-intensive for all parties and contributed to delays in the tender process. This experience highlighted that the efficiency and effectiveness of IT outsourcing tender processes in which cost savings have been identified as a primary objective and evaluation criterion will be enhanced to the extent that, in preparing for the tender process, agencies establish reliable and independently verifiable information about the service levels achieved under the existing internal service delivery models, their comparability with industry standards, and the resources applied in providing those services.

RFT consultation

5.18 Agencies may also be able to improve the efficiency and effectiveness of the tender process by obtaining early comment from potential tenderers to assist in the drafting of the technical and service specifications to be included in the RFT. The CPG state that, in the case of information technology requirements, agencies must make requests for tender available to potential tenderers in draft form for at least one month to allow for comment before finalisation.[115] A draft RFT was released in regard to the Cluster 3 tender, and draft technical material for the DEETYA/EN tender was released with the advance Notification to Industry.

5.19 OASITO advised ANAO that minimal comments were received from industry and that feedback from the participants at the conclusion of the tendering process suggested that the marginal benefits from releasing the material in draft form did not justify the time and effort involved. However, ANAO also noted that, in providing feedback on the Cluster 3 tender process, the Cluster agency representatives reported that the process of a draft and final RFT was generally supported and that industry comment on the draft RFT was useful. No draft RFT was released for the ATO and Group 5 tenders. Particularly in the case of the

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[115] CPG, July 1997 p.42 (current at the time the Cluster 3 RFT was released), and CPG: Core Policies and Principles, March 1998, p.8 (current at the time ATO and Group 5 RFTs were released).

Group 5 tender, it may have been useful to obtain industry comments on the requested service levels at an earlier stage given the extensive discussion during the tender process between agencies, OASITO and tenderers regarding the comparability of the service levels requested with industry standards.

5.20 OASITO advised ANAO that, since the DEETYA/EN tender, it had discussed the advantages and disadvantages of releasing draft material, and that a decision had been taken by agreement with agencies on a case by case basis. In December 1998, the Strategic Adviser advised OASITO that, by releasing draft technical documentation, industry would be given an opportunity to raise concerns about major issues in a less formal process than applies once the RFT is released. The Strategic Adviser noted that this approach had been adopted for the Health Group tender. DOFA advised ANAO in August 2000 that a similar approach had also been adopted in the Group 8 tender.

5.21 **Finding:** Agencies may often be able to improve the efficiency and effectiveness of the tender process by obtaining early comment from potential tenderers to assist in the drafting of the technical and service specifications to be included in the RFT. The CPG state that, in the case of information technology requirements, agencies must make requests for tender available to potential tenderers in draft form for at least one month to allow for comment before finalisation. A draft RFT was not released in regard to the ATO and Group 5 tenders.

Recommendation No. 9

5.22 ANAO *recommends* that, in future IT outsourcing tenders, relevant agencies consider the release of a draft Request for Tender for industry comment to assist in the development of IT offerings that will maximise competitiveness and support the achievement of cost-effective outcomes.

5.23 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response***: **Agree.** OASITO and Group Agencies will continue to determine, for each tender process, where the release of draft tender material in advance of the RFT release, is warranted. This decision has been taken in each tender process run under the IT Initiative to date.

Industry development tender outcomes

5.24 The ID objectives the Government desires to achieve through the IT Initiative are to:

a) support growth in the Australian IT&T industries;

b) promote the international competitiveness of the Australian IT&T industries; and

c) support employment growth and development in Regional Australia.

5.25 In each tender, the ID commitments proposed by the successful tenderer were assessed as adequately meeting the Government's ID objectives as set out in the RFT. In two tenders, Cluster 3 and ATO, the successful tenderer was assessed as the first-ranked tenderer in the ID evaluation. The circumstances applying in each of the tenders reviewed meant that it was not necessary for the preferred tenderer to be determined on the basis of a combined cost savings/ID assessment. However, the successful tenderer was required to contractually commit to the levels of ID activity proposed in its tender response. Those activities relate to both the delivery of the IT services ('in-scope commitments'), and to ID activities unrelated to the delivery of the IT services ('out-of-scope commitments').

5.26 In each case, the successful tenderer has made contractual in-scope ID commitments as to the proportion of service charges that will relate to high Australian value added activity (ranging from 69 percent in the ATO Agreement to 80 percent for Cluster 3) and the minimum proportion of service charges that will be paid to SME subcontractors (ranging from 6 percent under the Group 5 Agreement to 26 percent for ATO). Each ESP has also committed to a series of out-of-scope ID initiatives, including commitments in respect to minimum levels of strategic investment, exports and regional employment.

5.27 Although the Commonwealth retains the right under the Cluster 3, ATO and Group 5 Agreements to pursue a number of remedies in respect of non-performance of contractual obligations, including termination of the Agreement and suing for damages, the principal remedy established in respect of ID non-performance is payment by the ESP of agreed amounts where it does not fulfil its annual ID commitments. These amounts are referred to as 'sanctions' in the ATO and Group 5 Agreements, and 'liquidated damages' in the Cluster 3 Agreement. Figure 5.2 sets out a number of the ID commitments over five years under the Cluster 3, ATO and Group 5 Agreements in respect of which the relevant ESP has made a commitment to pay liquidated damages/sanctions for non-achievement. In some cases, the commitments for liquidated damages/sanctions purposes differ from individual commitments made.

Figure 5.2

ID commitments over 5 years for liquidated damages/sanctions purposes

	In-Scope Commitments		*Out-of-Scope Commitments*		
	Australian Value Added [1]	*SME Participation* [2]	*Strategic Investment* [3]	*Level of Exports* [4]	*Total Net Employment* [5]
Cluster 3	80%	24%	$39.75m	$55m	100 full time equivalent jobs
Group 5	$62.73m	$6.87m[6]	$1.2m	$29.1m	$23.92m in employment remuneration[7]
ATO	$285.5m	$108.6m[8]	$27m	$64.7m	250 full time equivalent jobs

Note 1: The percentage and/or quantum of overall service charges that the prime contractor has committed will relate to Australian value added products and services. 'Australian value added' means the supply price of products and services less the amount spent on imported products and services.

Note 2: The minimum percentage and/or quantum of overall service charges that the prime contractor has committed will be paid to SME subcontractors.

Note 3: The level of strategic investment the prime contractor has committed to make in the Australian IT&T industry over five years through initiatives unrelated to the delivery of the contracted services.

Note 4: The level of export revenue the prime contractor has committed to generate over five years through initiatives unrelated to the delivery of the contracted services. 'Exports' means the Australian value added content of IT&T products and services sold to foreign persons and exported from Australia.

Note 5: The level of net IT&T employment the prime contractor has committed to generate over five years. 'Net employment' means the number of full time equivalent jobs created in Australia over the relevant period additional to employment numbers in the base period prior to commencement of the Agreement.

Note 6: Relates to approximately 6 percent of total service charges over five years.

Note 7: 'Remuneration' means the average annual cost of employment per full time equivalent employee.

Note 8: Relates to approximately 26 percent of total service charges over five years.

Source: ANAO analysis of tender Evaluation Reports, Savings Models and OASITO documentation.

Monitoring achievement of ID commitments

5.28 DoCITA is responsible for monitoring achievement against the ID commitments. The Cluster 3, ATO and Group 5 Agreements require the relevant ESP to provide an annual report to DoCITA on its achievement against its ID commitments. The annual report must be independently audited at the ESP's expense. The first annual report was provided by the Cluster 3 ESP in June 1999 for the year ended 31 March 1999.[116] The ESP reported that all targets for both in-scope and

[116] Although the Cluster 3 Agreement commenced on 1 July 1998, the Agreement was executed on 31 March 1998. The ESP's ID commitments were adjusted to align with the timing differences where appropriate. A 31 March annual reporting date aligns with the ESP's internal reporting period.

out-of-scope commitments had been either met or exceeded. There was significant over-achievement reported in respect of strategic investment and out-of-scope employment.

5.29 Australian Auditing Standards (AAS) provide for three levels of audit and audit-related services, each of which provides a different level of assurance.[117] The Cluster 3 ESP engaged an accounting firm to perform agreed procedures on specified tables in its first ID annual report. The accounting firm reported that it had conducted the engagement in accordance with the AAS applicable to review engagements. Such engagements provide a lower level of assurance than do audit engagements.

5.30 In July 1999, DoCITA reported that it was satisfied with the scope of the review engagement, and the results of the review. However, ANAO noted that DoCITA did not appear to have been aware of the nature of the engagement until after the annual report was provided to it by the ESP, nor did there appear to be an adequate understanding of the level of assurance provided by the nature of the engagement undertaken.

5.31 The type of engagement that will be appropriate in particular circumstances relates to the nature of assurance being sought. In many cases, this will also be a cost/benefit assessment, with the cost of the engagement being affected by the nature of procedures undertaken by the auditor. In stipulating the requirement for the ESPs' annual ID reports to be independently audited, the Commonwealth is seeking a particular level of assurance regarding the information reported by the ESPs. However, it is the ESPs that engage and pay for the audit engagement.

5.32 A specialist review engagement or agreed procedures engagement may well be appropriate for the purposes of the Commonwealth in the monitoring of ESPs' achievement of ID commitments. However, ANAO

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[117] *'Assurance'* being the satisfaction as to the reliability of information provided. The degree of satisfaction achieved is determined by the nature and extent of procedures performed by the auditor, the results of the procedures and the objectivity of the evidence obtained, *AUS 104*, Australian Accounting Standards. The forms of engagement are *Audit* where the auditor's objective is to provide a high level of assurance through the issue of a positive expression of opinion that enhances the credibility of a written assertion about an accountability matter; *Review engagement* where the auditor's objective is to provide a moderate level of assurance, being a lower level of assurance than that provided by an audit, through the issue of a statement of negative assurance that enhances the credibility of a written assertion about an accountability matter, and *Agreed-upon procedures engagement* where the auditor's objective is to issue a report of factual findings to those parties that have agreed to the procedures to be performed, in which no conclusion is communicated and therefore no assurance is expressed, but which provides the user with information to meet a particular need, and from which the user can draw conclusions and derive assurance as a result of the auditor's procedures.

considers that it would be prudent for the Commonwealth to clarify the level of assurance it is seeking in regard to ESPs' ID reporting, and to ensure that the nature of engagement is agreed with the Commonwealth prior to its conduct. Following discussion with ANAO regarding this issue in November 1999, DoCITA commissioned its internal auditors to review its existing procedures and practices for ID monitoring, including audit requirements of ESPs' annual reports. As a result, a procedures manual was produced in March 2000 for use by the Department in the monitoring of ID commitments arising from the IT Initiative. The manual provides that, prior to an ESP commencing the audit of its annual ID report, it is required to agree the scope of the audit with DoCITA.

5.33 In commenting on the proposed audit report, the Cluster 3 ESP advised ANAO in August 2000 that:

> *In regard to Industry Development commitments,* [it] *has over-achieved generally. We do not believe that the nature of assurance provided by independent external review would have been significantly different, had it been conducted under a different AAS regime. However, we are certainly happy to agree the scope of future audits of the annual ID report with DoCITA.*

5.34 **Finding:** In each tender, the ID commitments proposed by the successful tenderer were assessed as adequately meeting the Government's ID objectives as set out in the RFT. In each case, the successful tenderer has made contractual in-scope ID commitments as to the proportion of service charges that will relate to high Australian value added activity (ranging from 69 percent in the ATO Agreement to 80 percent for Cluster 3) and the minimum proportion of service charges that will be paid to SME subcontractors (ranging from 6 percent under the Group 5 Agreement to 26 percent for ATO). Each ESP has also committed to a series of out-of-scope ID initiatives, including commitments in respect to minimum levels of strategic investment, exports and regional employment.

5.35 The Cluster 3, ATO and Group 5 Agreements require the relevant ESP to provide an annual report to DoCITA on its achievement against its ID commitments. The annual report must be independently audited at the ESP's expense. The first annual report was provided by the Cluster 3 ESP in June 1999 for the year ended 31 March 1999. The ESP reported that all targets for both in-scope and out-of-scope commitments had been either met or exceeded. There was significant over-achievement reported in respect of strategic investment and out-of-scope employment.

5.36 DoCITA has continued to improve its procedures and practices for ID monitoring, including audit requirements of ESPs' annual reports. As a result, a procedures manual was produced in March 2000 for use by the Department in the monitoring of ID commitments arising from the IT Initiative. The manual provides that, prior to an ESP commencing the audit of its annual ID report, it is required to agree the scope of the audit with DoCITA.

Confirmation of subcontractor arrangements

5.37 It is appropriate for the Commonwealth to confirm, prior to executing the Services Agreement, that the commitments made by the prime tenderer have been agreed with its nominated subcontractors, and are supported by appropriate contractual arrangements. In many cases, the subcontractors will be SMEs that also contribute to the prime tenderer's ID commitments. Such confirmation was not sought in respect of the Cluster 3 Agreement executed in March 1998. In April 1998, the Strategic Adviser recommended to OASITO that clauses directed at assisting this process be inserted into future RFTs, including those for the ATO and Group 5. Clauses were subsequently inserted requiring confirmation of subcontractor arrangements from both the relevant subcontractors, and from the prime tenderer.

5.38 Firstly, the Group 5 RFT stated that, as a condition of contract execution, the successful tenderer would be required to provide a letter from each SME subcontractor confirming that appropriate contractual arrangements were in place to assure that entity's role in the provision of services under the Agreement on the basis described in the tenderer's ID proposal. The ATO RFT included a similar requirement.[118]

5.39 ANAO found no evidence of such confirmation having been obtained by OASITO from SME subcontractors proposed by the Group 5 prime tenderer prior to the execution of the Agreement. OASITO was also unable to provide ANAO with evidence of such confirmation having been obtained from SME subcontractors proposed by the ATO prime tenderer. However, in commenting on the proposed audit report in August 2000, the ATO prime tenderer advised ANAO that it provided OASITO with a completed statutory declaration from 11 of its 12 nominated subcontractors

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118 The requirement in the ATO RFT was stated in more discretionary terms in that the successful tenderer '*may be required*' to provide such a letter. But it was also broader in some ways in that such letters could also be required of the prime tenderer in regard to any SME participating in their ID initiatives, whether as a subcontractor or not; and related to SMEs' roles in either the provision of the Services or participation in relevant ID initiatives. The Group 5 provision related only to SME's roles as described in the ID proposal.

prior to the contract execution. Under the statutory declaration, the nominated subcontractor confirmed it was aware of the relevant contractual terms and conditions of the Services Agreement and would be entering into a subcontract with the ATO ESP in the near future on terms that would not be inconsistent with the Services Agreement.

5.40 Secondly, the ATO and Group 5 Agreements also included a clause to the effect that the prime tenderer 'represents and warrants' that, at the date of signing of the Agreement, appropriate contractual arrangements were in place with approved subcontractors specified in the ID Plan (and any other SME participating in the ID Plan) to assure those entities' role in the provision of Services or participation in the relevant ID initiatives on the basis described in the Agreement. Prior to execution of the ATO Agreement, the successful prime tenderer provided OASITO with an undertaking in respect of that warranty in which it confirmed that it expected to have appropriate contractual arrangements in place with 11of 12 subcontractors prior to execution of the Agreement on 31 March 1999. OASITO was unable to provide ANAO with documentation of such confirmation having been obtained from the relevant prime tenderer prior to the execution of the Group 5 Agreement.

5.41 At the time of executing the Group 5 Agreement on 14 April 1999, the Group 5 ESP did not have subcontracts in place with the SMEs identified in its tender for the delivery of applications development and maintenance (ADM) services, and IT training services. The ESP notified the Commonwealth that it had completed a contract with the ADM SME on 2 December 1999, and with a replacement IT training services provider on 6 January 2000. In commenting on the proposed audit report, the Group 5 ESP advised ANAO in August 2000 that:

> *Negotiations with subcontractors were advanced. However,* [we] *could not execute subcontracts until the prime contract was signed. After execution, negotiations stalled with one subcontractor. At all times* [we] *proceeded in good faith.*

5.42 **Finding:** There is scope for improvement in the management of compliance issues associated with confirmation of prime contractors' contractual arrangements with subcontractors prior to contract execution. ANAO found no evidence of OASITO having obtained such confirmation from SME subcontractors proposed by the Group 5 prime tenderer prior to the execution of the Agreement, despite its provision being a condition of tender, or of confirmation being sought from the Group 5 prime tenderer prior to the execution of that Agreement. The ATO ESP advised ANAO that confirmation was provided to OASITO by 11 of its 12 subcontractors prior to contract execution, but OASITO was not able to provide ANAO with documentation of that confirmation.

Evaluation reporting

5.43 The tender documents released to potential tenderers establish the basis on which the Commonwealth must determine the outcome of a tender process.[119] Good administrative practice is for the evaluation process to include documented consideration of all evaluation criteria, including the satisfaction of identified preconditions to the awarding of a contract. The assessment of each tenderer, and any decision to award a contract as a result of the tender, must reflect the requirements contained in the RFT. The quantitative and qualitative elements taken into account in assessing whether those criteria had been met, or in determining whether it was still necessary for a criterion to be achieved, should be clearly identified in the formal evaluation documentation and the advice provided to the decision-maker.

Documentation of evaluation committee conclusions

5.44 The tender documents released to potential tenderers in respect of the Cluster 3, ATO and Group 5 tenders stipulated the criteria for determining the outcome of the tender. These reflected the identified primary objectives of cost savings and ID, and underlying threshold requirements in respect to service and risk. Each RFT also stated the Commonwealth would not award a contract unless it was satisfied that the preferred tenderer would deliver a substantial and acceptable level of cost savings based on an assessment against criteria relating to cost savings specified in the RFT.

5.45 The cost savings evaluation encompassed a group of financial criteria relating to the extent to which a tenderer's pricing and pricing structure would maximise cost savings, maintain competitiveness and provide predictability, gain-sharing and flexibility. Therefore, the determination as to whether a particular tenderer had satisfied the cost savings precondition would require a conclusion to be drawn, based upon the detailed assessments against each criterion. The terms 'cost savings',

[119] AGS advised ANAO that: *this has become an important issue in recent times as it is now increasingly more common for tenderers to challenge tender processes conducted by the Commonwealth and its agencies, as shown in cases such as Hughes Aircraft Systems International v Airservices Australia (1997) 146 ALR 1 and JS McMillan and others v Commonwealth of Australia (1997) 147 ALR 419. In the Hughes case the court found that a contract was formed between a tenderer and the Civil Aviation Authority (CAA) in relation to a tender process, and that an implied term of this contract (and those involving other public bodies spending publicly owned funds) was that the CAA must deal with tenderers fairly. The court held, among other things, that the CAA had breached this 'pre-contract' contract with the tenderer by failing to evaluate the tender in accordance with the methodology set out in the tender documents and the priorities assigned to the evaluation criteria.*

'substantial' and 'acceptable' were not specifically defined.[120] In those circumstances, it becomes a matter of judgement as to whether the condition has been satisfied in a particular tender.

5.46 The Group 5 tender evaluation identified pre-CN direct savings to the Group agencies of $0.96 million over five years (NPV $0.17 million), and notional savings of $8.3 million (NPV $6.02 million) after the application of CN adjustments. The preferred tenderer was assessed as acceptable against the other cost savings criteria. In the context of the Group 5 tender, OASITO was advised by its Legal Adviser in March 1999 that the Commonwealth had a broad discretion under the RFT to determine what constituted 'cost savings' for the purpose of the cost savings evaluation criteria. The Legal Adviser also advised that the Commonwealth had a broad discretion to determine what extent of those cost savings constituted a 'substantial and acceptable' level of cost savings for the purpose of satisfying itself that the cost savings precondition had been complied with. It was noted that such judgement by the decision-maker should be based upon some material before the Commonwealth that could reasonably be said to support a conclusion that the extent of cost savings was 'substantial and acceptable'.

5.47 The manner in which the requirement for substantial and acceptable cost savings was expressed in the Cluster 3, ATO and Group 5 RFTs meant that it was a key factor to be applied in the evaluation process. In those circumstances, it could be expected that the Committees responsible for the evaluation would formally address in their advice and recommendations to the relevant Ministers whether, in their view, the cost savings precondition had been satisfied by the recommended preferred tenderer. That was <u>not</u> the case in the ATO and Group 5 tenders.

5.48 The evaluation structure determined for each tender identified the parties responsible for forming assessments in regard to the evaluation criteria, and for providing those assessments to the relevant Ministers. In each case, the tender evaluation plan provided that, based on the report of the IT Services Evaluation Committee, the Steering Committee would determine whether each tenderer had satisfied the threshold criteria identified in the RFT relating to cost savings, and service and risk. The Steering Committee's findings relating to the threshold criteria and value for money rankings were then to be submitted to the Options Committee, which would also consider the ID Evaluation Report in formulating selection options for consideration by Ministers.

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120 In December 1997 the (then) Legal Adviser to the IT Initiative advised OASITO that the criterion relating to the achievement of 'substantial' cost savings was a potential area of difficulty, noting that the notion of 'substantial' was not defined. The Legal Adviser advised OASITO that it understood the need for a degree of imprecision here and that it should not cause problems as long as each of the tenderers was treated in the same way as far as the application of the 'substantiality' test.

5.49 In each tender, there was a clear conclusion drawn by the respective Committees as to the adequacy of tenderers' bids against the threshold service and risk criteria, and identified ID objectives. Each tender process also documented the cost savings offered by each tenderer as quantified by the financial evaluation undertaken, together with an assessment of the acceptability or otherwise of tenderers' pricing proposals against the cost savings criteria relating to on-going competitiveness, predictability, gain-sharing and flexibility. However, as noted, the determination as to whether a tenderer had satisfied the overarching cost savings precondition required that a conclusion be drawn from the detailed assessments against these individual criteria.

5.50 The Cluster 3 Evaluation Committee formally reported a conclusion that each of the three tenderers offered substantial cost savings for the Cluster as a group. However, in the ATO and Group 5 tender evaluations, the relevant Committees reported no conclusion in respect of the satisfaction or otherwise of the cost savings precondition. The documentation prepared by the ATO and Group 5 Evaluation Committees, Steering Committees and Options Committees, and the documented advice provided to the Minister by those Committees, did not address the question of whether the precondition of substantial and acceptable cost savings stipulated in the RFT had been satisfied. The Group 5 Evaluation Committee reported that the preferred tenderer would generate '*modest savings*' of almost $1 million over five years in undiscounted terms.

5.51 In transmitting the Group 5 Options Committee recommendation of preferred tenderer to the Minister for Finance and Administration, OASITO noted that the notional savings were modest, but advised that those savings did not recognise improved services being obtained by the agencies such as improved disaster recovery and business continuity, high guaranteed service levels[121] and enhanced security. OASITO advised that, in its opinion therefore, the preferred tenderer had met the savings criteria in the RFT.

[121] ANAO notes that service levels provided by ESPs are only effectively 'guaranteed' to the extent that the ESP may be subject to some form of remedy under the contractual arrangement where a service level is not achieved. This may involve termination of all or part of the contract or damages. But the more practical day-to-day remedy will be payment by the ESP of service credits, if agencies elect to apply that discretionary provision. It can be expected that, where a difficulty in achieving service levels may be experienced, ESPs will apply commercial judgements regarding the relative costs and benefits of those potential service credits as compared to investing in additional capability and redundancy that may be needed to more fully 'guarantee' achievement of a the specified levels of service.

Implications of policy statement for tender evaluations

5.52 After the close of the ATO and Group 5 tenders, but before the completion of the tender evaluations, the Prime Minister clarified Government policy regarding the IT Initiative.[122] In December 1998, the Prime Minister advised all Portfolio Ministers that *'as a general Government policy, outsourcing of IT infrastructure services should proceed unless there was a compelling business case on a whole-of-Government basis for not doing so.'* The timing of the December 1998 policy statement meant that it had the potential to introduce a new factor into the environment in which the ATO and Group 5 tender evaluations, then underway, were being conducted.

5.53 In March 2000, OASITO advised ANAO that this policy effectively created a *'rebuttable presumption'* in favour of outsourcing; that is, outsourcing is to proceed unless a compelling case against outsourcing is established having regard to all of the Government's objectives and the expected non-financial benefits from outsourcing. In April 2000, OASITO further advised ANAO that the Prime Minister's December 1998 letter arguably minimised the significance of the precondition requiring substantial and acceptable cost savings before a contract would be awarded; and that the undefined terms 'substantial' and 'acceptable' should be interpreted in the light of that letter.[123]

5.54 It is reasonable to expect that the basis on which the Commonwealth stipulates that it intends to decide the outcome of a tender will influence the decision by potential tenderers as to whether to participate in the tender, and the nature of bids submitted. Subsequently altering that basis has the potential, in certain circumstances, to give rise to challenges to the tender process. It would also be inconsistent with the requirements under the CPG. AGS advised ANAO that:

> *The requirement to evaluate the tender responses in accordance with the objectives set out in the evaluation criteria is essentially based on the need to ensure that all tenderers are treated fairly and equally in the tender process. This obligation arises from the Financial*

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[122] The Cluster 3 tender was completed prior to the Prime Minister's December 1998 letter.

[123] In January 1999, OASITO advised the members of the Group 5 Steering Committee of the contents of the Prime Minister's December 1998 letter, noting that a key point of the letter was that, as general Government policy, outsourcing should proceed unless there was a compelling business case against it on a whole of Government basis. The advice from OASITO also noted that, in foreshadowing the letter from the Prime Minister at the Steering Committee meeting before Christmas 1998, OASITO had offered the "private" view that it now considered a Group 5 outsourcing decision to be a virtual certainty, and that agencies should be concerned that they aggressively pursue the very best outsourcing deal that they can in terms of cost and service delivery. As at December 1998, savings had not been identified against any of the Group 5 tenderers.

Management and Accountability Act 1997 (FMA) (and associated FMA Regulations) and the Commonwealth Procurement Guidelines. FMA Regulation 9 provides that a procurement approver must not approve a proposal to spend public money unless they are satisfied (after reasonable inquiry) that the proposed expenditure is, among other things, in accordance with the policies of the Commonwealth. The procurement policies of the Commonwealth are set out in the Commonwealth Procurement Guidelines (issued by the Finance Minister under FMA Regulation 7(1)), and Regulation 8(1) provides that an official performing duties in relation to the procurement of property or services must have regard to these Guidelines.

Part 2 of the Commonwealth Procurement Guidelines on Open and Effective Competition provides guidance to procurement officers on maintaining openness and transparency in the tendering process.[124] *This policy essentially places a responsibility on those involved in government procurement to conduct tendering processes in a fair and even handed manner, and to allow all tenderers to be equally informed of the basis upon which their offers will be assessed. In meeting this responsibility, it is therefore crucial that only the criteria notified to tenderers in the RFTs are used to evaluate the tenders. If the tenders are evaluated on any other basis, an unsuccessful tenderer aggrieved at a decision may have grounds to legally challenge the tender process and seek compensation.*

5.55 In respect to the ATO and Group 5 tenders, AGS further advised ANAO that:

From a legal perspective, taking specific account of the policy statement contained in the Prime Minister's letter in selecting preferred tenderers should only occur if the content of the policy statement was consistent with the evaluation criteria originally notified to tenderers in each RFT or if OASITO was able to amend the RFT process, in a way which did not treat tenderers unfairly in order to take into account the new policy statement.

If the content of the policy statement was inconsistent with the evaluation criteria and was relied upon to select the preferred tenderer, that would be a departure from the stated criteria to be used for tender evaluation as set out in each RFT and risks leaving the Commonwealth

[124] On page 8 the following Commonwealth policy is outlined: *the evaluation criteria for any particular procurement should clearly identify the relative importance of all relevant factors, and provide a sound basis for a procurement decision. Agencies should evaluate each offer applying only the evaluation criteria and methodology notified to bidders in the request for tender documentation.*

> *open to claims from aggrieved tenderers that the tender process was not conducted fairly.*
>
> *Where the policy statement is used to interpret the meaning of an undefined term in the RFT, such as the term "substantial", this would be acceptable as long as the resulting interpretation is still within the ordinary English meaning of the term.*

5.56 ANAO considers that there was potential for the policy statement to be interpreted and applied in the ATO and Group 5 tender evaluations in a manner inconsistent with the selection preconditions set out in the respective RFTs. In particular, the application in the tender evaluation process of a conclusion that the policy statement had created a 'rebuttable presumption' in favour of outsourcing would appear to be inconsistent with the RFT requirement that the preferred tenderer pass the positive test of substantial cost savings.

5.57 In such circumstances, there is a heightened need for the factors considered in any decision to award a contract in respect of a tender process to be appropriately documented/recorded. However, it is unclear to ANAO from the available evaluation documentation whether the December 1998 policy statement was considered in either evaluation, and if so, how. ANAO considers that the transparency and accountability of the decision making process in the ATO and Group 5 tenders would have benefited from improved documentation/recording of the respective evaluation Committees' conclusions and advice as to whether the preconditions stipulated in the RFT had been satisfied by the recommended preferred tenderer, and the factors considered in reaching that conclusion.

5.58 **Finding:** The Cluster 3, ATO and Group 5 RFTs stated that the Commonwealth would not award a contract unless it was satisfied that the preferred tenderer would deliver a substantial and acceptable level of cost savings based on an assessment against the criteria specified in the RFT. The cost savings evaluation encompassed a group of financial criteria relating to the extent to which the tenderers' pricing and pricing structure would maximise cost savings, maintain competitiveness and provide predictability, gain-sharing and flexibility. Therefore, the determination as to whether a particular tenderer had satisfied the cost savings precondition would require a conclusion to be drawn, based upon the detailed assessments against each criterion. The terms 'cost savings', 'substantial' and 'acceptable' were not specifically defined.

5.59 The manner in which the requirement for cost savings was expressed in the RFTs meant that it was a key factor to be applied in the evaluation process. In those circumstances, it could be expected that the Committees responsible for the evaluation would formally address in their documented advice and recommendations to the relevant Ministers whether, in their view, the cost savings precondition had been satisfied by the recommended preferred tenderer. That was not the case in the ATO and Group 5 tenders.

5.60 After the close of the ATO and Group 5 tenders, but before the completion of the tender evaluations, the Prime Minister clarified Government policy regarding the IT Initiative. In December 1998, the Prime Minister advised all Portfolio Ministers that, as a general Government policy, outsourcing of IT infrastructure services should proceed unless there is a compelling business case on a whole-of-Government basis for not doing so. In April 2000, OASITO advised ANAO that the Prime Minister's December 1998 letter arguably minimised the significance of the precondition requiring substantial and acceptable cost savings before a contract would be awarded; and that the undefined terms 'substantial' and 'acceptable' should be interpreted in the light of that letter.

5.61 There was potential for the policy statement to be interpreted and applied in the ATO and Group 5 tender evaluations in a manner inconsistent with the selection preconditions set out in the respective RFTs. In those circumstances, there is a heightened need for the factors considered in any decision to award a contract in respect of a tender process to be appropriately documented/recorded. However, it is unclear to ANAO from the available evaluation documentation whether the December 1998 policy statement was considered in the ATO and Group 5 evaluations, and if so, how. ANAO considers that the transparency and accountability of the decision making process in the ATO and Group 5 tenders would have benefited from improved documentation/recording of the respective evaluation Committees' conclusions and advice as to whether the preconditions stipulated in the RFT had been satisfied by the recommended preferred tenderer, and the factors considered in reaching that conclusion.

Recommendation No. 10

5.62 ANAO *recommends* that, in future IT outsourcing tenders, relevant agencies enhance the transparency and accountability of decision making by documenting explicit consideration of the extent to which tenderers comply with all evaluation criteria and preconditions identified in the Request for Tender.

5.63 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response***: **Agree.** All tender processes have considered the extent to which tenderers comply with all evaluation criteria.

6. IT Services Evaluation Outcomes

This chapter discusses the outcomes of the IT services evaluations for the Cluster 3, DEETYA/EN, ATO and Group 5 tenders.

Introduction

6.1 The RFT released in respect of the Cluster 3, DEETYA/EN, ATO and Group 5 tenders identified the objectives of the IT services element of the tender as being:

a) effective IT&T support of agency business needs and service delivery requirements;

b) substantial economies of scale resulting in improved efficiency, cost effectiveness and significant savings to the budget and to agencies;

c) improved effectiveness by moving to more standardised operating environments;

d) more efficient use of processing capacity;

e) improved service levels at lower costs;

f) leveraging access to private sector technology and know how;

g) improved technology solutions; and

h) improved potential for staff career development in an environment where IT&T is the core business.

6.2 The extent to which a number of those objectives will be achieved can only be determined over the term of the respective Agreements. The IT services evaluation process involved the assessment of tenderers' proposed solutions against threshold service and risk and cost savings criteria. In that process, the respective evaluation teams formed conclusions regarding the expected capacity of tenderers to effectively service agencies' IT and business requirements. The evaluation also identified the level of savings projected to be provided by each tenderer.

6.3 In the Group 5 tender, the successful tenderer was preferred when judged against the service and risk criteria. In the Cluster 3 tender, the successful tenderer was considered comparable with the second-ranked tenderer from a service and risk perspective. The technical solution of the second-ranked tenderer was considered slightly more robust, but the difference was not viewed as sufficient to justify the payment of a significant price premium. In the ATO tender, each of the two compliant tenderers were assessed as presenting an acceptable level of service and risk when measured against the criteria set out in the RFT. In the Cluster 3 and ATO tenders, the evaluation teams identified a range of additional actual and/or potential benefits arising from the contractual arrangements and the successful tenderers' proposed use of improved technology solutions.

6.4 Under the IT Initiative, specific financial benefits were expected to result from the strategy of consolidation and outsourcing due to the improved potential for economies of scale and efficiencies in support systems and facilities. A number of the areas in which financial benefits from outsourcing were identified, in each of the tenders reviewed, reflected those factors.

6.5 In each case, the successful tenderer offered the lowest price by a clear margin compared to other tenderers. Each had also indicated a willingness to enter into gain sharing arrangements[125] and, to the extent that can be reasonably assured in an outsourcing contract, was considered acceptable in terms of the requirements for a pricing structure that would remain competitive, predictable and flexible.

6.6 Under the cash-based financial evaluation methodology applied by OASITO, the aggregate direct cost savings to agencies projected across the Cluster 3, ATO and Group 5 tender evaluations at the selection of preferred tenderer were $123.36 million over five years ($97.17 million in NPV terms). The savings identified in the Group 5 tender at that stage amounted to a modest $0.96 million or less than one percent of agency baseline costs (NPV $0.17 million). The Cluster 3 and ATO evaluations identified savings of $62 million or 28 percent (NPV $49.9 million) and $60.4 million or 10 percent (NPV $47.1 million) respectively.

[125] The successful tenderer in the Group 5 tender was assessed as acceptable in terms of providing gain-sharing arrangements, but was considered to have provided a shortage of detail on how it would provide such arrangements. This was identified as an area where the Group may be exposed to cost risks.

Comparison with Budget reductions

6.7 In announcing the IT Initiative in the 1997-98 Budget, the Government applied reductions to agency forward estimates which were described as estimates of the minimum net savings agencies could be expected to achieve through the consolidation and outsourcing of IT infrastructure. However, for a variety of reasons, it is difficult to draw direct parallels between the savings identified in the individual tender processes, and the reductions made to agency forward estimates. This difficulty increases with the passage of time between the announcement of the IT Initiative and the conduct of a particular tender. The financial evaluation conducted for each tender did not include quantification of the extent to which agencies may have achieved improved efficiency and cost savings internally in preparation for the tender process, or had projected reduced future costs in anticipation of achieving such efficiencies.

6.8 The Budget reductions were applied in the context of the cash budgeting system then in operation in the Commonwealth Budget sector, and represented an absolute decrease in the budget funding available to agencies in future periods. However, the bundle of services previously delivered by agencies through that budget funding may not be comparable with the bundle of services, and associated costs, sought under the respective RFTs and considered in the tender evaluation. For example, the Cluster 3 RFT identified a requirement for a major upgrade of existing infrastructure during the period of the proposed outsourcing Agreement.

6.9 In addition, the OGIT/DOF Evaluation, on which the Budget reductions were based, considered the potential savings from the consolidation and outsourcing of mainframe, midrange and desktop/ network services. It did not consider the costs or potential savings associated with voice telecommunications or applications development and maintenance services.[126] The inclusion of those services in the competitive tender process under the IT Initiative is optional for agencies. Each tender reviewed in this audit included voice telecommunications services, and the Group 5 tender included applications development and

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126 Compulsory annual reductions were made to agency budgets in the 1996-97 Budget based on an estimate of the minimum savings which were expected to be generated through the introduction of whole-of-Government telecommunications arrangements. The net reductions were $7.5m in 1996-97 and some $70m in subsequent outyears. These reductions were in addition to the reductions subsequently made to agency budgets in respect of mainframe, midrange and desktop IT services in the 1997-98 Budget under the IT Initiative. See Audit Report No. 9 1997-98 *Management of Telecommunications Services in Selected Agencies*, pp 31-32.

maintenance services for two of the five Group agencies. Consequently, the total savings projected under the Cluster 3, ATO and Group 5 tenders included savings for services not considered in the original Budget reductions.

6.10 The savings identified in each tender process were also influenced by the employee transition approach adopted. The savings estimated in the OGIT/DOF Evaluation assumed a 'phased' employee transition approach. Under that approach, agencies negotiate with the successful tenderer for the employment of agency staff, and there is limited ability for staff to obtain voluntary redundancy payments. However, in each of the tenders reviewed in this audit, the agencies adopted a 'clean break' approach under which employees were able to take a voluntary redundancy payment and then seek employment with the successful tenderer if they chose. This approach represented a higher up-front cost for agencies than the phased approach, and is likely to have reduced the projected savings for those agencies compared to the savings estimated by the OGIT/DOF Evaluation.

6.11 OASITO advised ANAO that it considered that the financial evaluations had produced conservative savings estimates. OASITO noted examples of areas where additional savings might be generated, but advised ANAO that it had not pursued those savings with agencies because it was not considered necessary in order to implement the Government's outsourcing policy.[127]

[127] For example, OASITO advised ANAO that the agency cost models did not include an allowance for inflation from the date the costs were captured until the end of the first contract year; whereas the tendered prices, fixed until the inflation formulae take effect in the second year, included the effect of inflation until then. OASITO advised that the comparison of prices and internal costs was therefore not done strictly on a 'like for like' basis. OASITO advised that recalculating agency costs assuming relatively conservative increases in staff costs during the relevant period would increase the reportable savings for Cluster 3 by $4.3m, $5.4m for ATO and $1.1m for Group 5. The Group 5 CMO questioned this estimate, noting that OASITO's estimated additional savings for Group 5 would mean an increase of well over $10,000 per staff member over the relevant period. Increases at this rate were considered unlikely given the rate at which public sector salaries have risen. The CMO also noted that the inflation adjustment after year 1 under the Group 5 Agreement was likely to increase costs over that likely to be experienced in the agency business-as-usual case. This was on the basis that IT equipment prices have shown a downward trend in actual prices, and the CPI adjustment in the Agreement would be likely to outstrip the conservative growth in public sector wages.

6.12 Figure 6.1 compares the cash reductions applied to agency budgets with the estimated relative saving in agency cash outlays under the respective outsourcing Agreements for the corresponding five year period and lines of service. The comparison is made before the application of notional CN adjustments, and after excluding savings projected in respect of voice telecommunications and applications development and maintenance services. The aggregate relative savings in agency cash outlays projected in the Cluster 3, ATO and Group 5 tender evaluations represented about four-fifths of total reductions to those agencies' budgets for the relevant five year periods and lines of service. Total agency cash budget reductions over the relevant five year periods exceeded projected relative agency savings in cash outlays under the respective Agreements by $24.6 million. However, there was significant variability in the extent to which the direct agency savings calculated in the context of the Cluster 3, ATO and Group 5 tenders corresponded with the reductions to agency budgets. This analysis should be viewed in the light of the qualifying factors identified above.

Figure 6.1

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

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

Note1: The ATO tender evaluation projected direct financial savings to ATO of $42.7 million at final contract stage (excluding voice network). Due to the CN methodology applied, this did not include sales tax costs of $3.6m included in the contracted pricing. Although neutral at a whole-of-Government level, those costs are relevant for the purposes of comparing the ATO's expected cash outcomes under the outsourcing Agreement with the cash budget reductions and are included in this analysis.

Note2: Excludes Budget reductions of $1.86m applied in 1998-99 prior to contract commencement.

Source: Cluster 3, ATO and Group 5 tender evaluation reports, OASITO documentation and ANAO analysis

6.13 The cost savings projected over the five year term of the Cluster 3 Agreement were over one and a half times the $33.4 million reduction to Cluster agency cash budgets for the corresponding period and services. However, the cost savings expected to be accrued under the outsourcing Agreement do not represent an absolute decrease over the cash outlays previously incurred by agencies. This is largely due to the requirement for the ESP to implement and support a significantly upgraded IT infrastructure within a number of Cluster agencies. Analysis by the Cluster 3 Contract Management Office (Cluster 3 CMO) suggested that, after normalising the agency cost baseline for actual volumes consumed under the Agreement, cost savings were realised across the Cluster in the first year of operation at about 80 percent of the rate forecast in the tender evaluation for the corresponding period and costs (see Chapter 8).[128]

6.14 In the case of Group 5 and the ATO, the relative cash savings expected to be achieved by agencies through the operation of the respective outsourcing Agreements (compared to continuing internal service delivery) were significantly less than the reductions applied to agency budgets. Based on the final contracted pricing, excluding voice telecommunications and applications development and maintenance services, Group 5 agencies are expected to realise relative cash savings over the five year term of an estimated $0.3 million. This is about 3 percent of the reductions to Group agency budgets for the corresponding period and services, which totalled $9.6 million and also excluded consideration of voice telecommunications and applications development and maintenance.

6.15 Reductions to the ATO's cash budget for the five year period corresponding to the term of the outsourcing Agreement totalled $76.3 million and excluded consideration of voice telecommunications. When voice telecommunications is excluded from the savings identified in the ATO tender evaluation, the ATO was projected to accrue direct savings over the five year term of $42.7 million at the final contract stage. Due to the methodology used to calculate CN adjustments in the ATO tender, this did not include consideration of $3.6 million in sales tax-related costs included in the contracted pricing. As this cost represents an identifiable cash outlay to be incurred by the ATO under the terms of the Agreement, it is relevant for comparing the tender evaluation savings with the cash budget reductions applied in the 1997-98 Budget. After including this cost, the ATO is expected to realise savings in cash outlays of $39.1 million over the term of the Agreement, or just over half of the budget reductions.

[128] These savings include the reduction in payments from service credits imposed in 1998-99. This analysis excludes consideration of transitional costs. The savings identified by the Cluster 3 CMO also exclude DOFA bureau customers.

6.16 **Finding:** In each tender reviewed, the successful tenderer offered the lowest price by a clear margin compared to other tenderers, and was assessed as either preferred or comparable in terms of service and risk. The aggregate cost savings projected across the Cluster 3, ATO and Group 5 tender evaluations at the selection of preferred tenderer were $123.36 million over five years ($97.17 million in NPV terms). The savings identified in the Group 5 tender amounted to a modest $0.96 million or less than one percent of agency baseline costs (NPV $0.17 million). The Cluster 3 and ATO evaluations identified savings of $62 million or 28 percent (NPV $49.9 million) and $60.4 million or 10 percent (NPV $47.1 million) respectively.

6.17 For a variety of reasons, it is difficult to draw direct parallels between the savings identified in the individual tender processes, and the reductions made to agency forward estimates in the 1997-98 Budget. This difficulty increases with the passage of time between the announcement of the IT Initiative and the conduct of each tender. In particular, the financial tender evaluations conducted did not quantify the extent to which agencies may have improved internal efficiency in preparation for the tender process. They also included services not considered in the calculation of the agency budget reductions, particularly voice telecommunications and applications development and maintenance services. After excluding savings projected in respect of those services, the aggregate relative savings in agency cash outlays projected in the Cluster 3, ATO and Group 5 tender evaluations represented about four-fifths of total reductions to those agencies' budgets for the relevant five year periods and lines of service. Cash budget reductions exceeded projected relative savings in cash outlays by $24.6 million.

6.18 However, there was significant variability in the extent to which the direct agency cash savings calculated in the context of the individual tenders reviewed corresponded with the reductions to agency budgets. Expected savings for Cluster 3 were over one and a half times the reductions to agency budgets. Analysis by the Cluster 3 CMO suggested that cost savings were realised by agencies in the first year of operation at about 80 percent of the rate forecast in the tender evaluation for the corresponding period and costs. For the ATO and Group 5 agencies, the relative savings in cash outlays expected to be achieved through the outsourcing Agreements (compared to continuing internal service delivery) were significantly less than the reductions applied to agency budgets (representing 51 percent and 3 percent of the budget reductions respectively). This analysis considered the estimated savings in relative agency cash outlays under the contracted pricing before the application of notional CN adjustments, and should be viewed in the light of the qualifying factors identified above.

Cluster 3 and DEETYA/EN tender outcomes

6.19 Cluster 3 was the first tender conducted under the IT Initiative. The Cluster 3 Evaluation Committee concluded that each of the three tenderers offered substantial cost savings, with the first-ranked tenderer being assessed as providing the lowest-priced bid. On 24 February 1998, the Cluster 3 Options Committee recommended that the tenderer ranked first in both the IT services and ID evaluations be selected as preferred tenderer. The recommendation was endorsed on 5 March 1998. OASITO advised the Minister for Finance and Administration on 25 March 1998 that final negotiations with the preferred tenderer had progressed successfully.[129] The Services Agreement was executed on 31 March 1998 and services handed over on 1 July 1998. The savings projected for the Cluster as a whole at final contract were $63.2 million over five years or 29 percent of the Cluster cost baseline ($50.9 million in NPV terms[130]). Notional savings after the application of CN adjustments, as calculated by OASITO, were $96 million or 38 percent (NPV $77.8 million).[131]

6.20 Tenders closed for the second IT Initiative tender involving Department of Employment, Education, Training and Youth Affairs (DEETYA) and Employment National (EN) on 14 April 1998 with only one bid received. Following consideration of the available options, OASITO determined that the single bid would be subjected to an evaluation process in accordance with the evaluation plan. The evaluation assessed the single bid as being deficient against both financial and technical evaluation criteria. The Project Steering Committee concluded that the bid did not satisfy the threshold criteria relating to service and risk, and that the likelihood of achieving positive savings was sufficiently remote to make pursuit of concessions through negotiation a cost-ineffective option. Initial evaluation of the tendered ID offering was that it did not meet the Commonwealth's objectives and was inadequate. The tender process was discontinued on 11 June 1998.

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129 The financial evaluation identified that no savings would be available in respect of DIST Head Office Voice. This position was unable to be improved during final negotiations with the Preferred Tenderer. This component was excluded from the final Cluster 3 Services Agreement. OASITO noted that the excluded component represented less than 2 percent of the contract value and would not result in a negative financial effect on the other agencies.

130 Based on an 8 per cent discount rate.

131 At the time of evaluation, substantial savings were not projected for the DIST agencies included in the Cluster, AGAL, AUSLIG and IPS. Combined NPV projected savings were $173,611 over five years, or 2.5 percent. DIST was advised by OASITO on 14 May 1998 that, following review of the agency cost baselines and redistribution within the Cluster of costs and the proceeds from the sale of assets, combined NPV savings for those agencies had been recalculated to be $1.9m over five years, or 23.2 percent.

6.21 **Finding:** The tenderer ranked first in terms of both IT services and industry development was selected as the preferred tenderer for Cluster 3. The Services Agreement was executed on 31 March 1998 and services handed over on 1 July 1998. The savings projected for the Cluster as a whole at final contract were $63.1 million over five years or 28 percent of the Cluster cost baseline ($50.9 million in NPV terms). Notional savings after the application of CN adjustments, as calculated by OASITO, were $96 million or 38 percent (NPV $77.8 million).

6.22 In the DEETYA/EN tender, the Project Steering Committee concluded that the single bid received did not satisfy the threshold criteria relating to service and risk, and that the likelihood of achieving positive savings was sufficiently remote to make pursuit of concessions through negotiation a cost-ineffective option. The tender process was discontinued on 11 June 1998.

ATO tender outcomes

6.23 Following parallel negotiations with the two compliant tenderers in the ATO tender, final pricing offers were received on 4 March 1999. The Financial Team concluded that, without taking competitive neutrality into account, only one tenderer would return savings to the ATO. The first ranked tenderer was assessed as offering savings over a five year term of $60.44 million or 10.6 percent over the agency baseline (NPV $47.1 million[132]). The direct financial savings to the ATO were overstated by $3.91 million as the evaluation did not consider sales tax-related costs that the tenderer had advised were a component of the price bid for

132 The ATO IT&T Services Final Evaluation Report included NPV savings that had been miscalculated and were overstated. NPV savings calculated using discount rates of 8 percent and 5.74 percent were reported as $55.96m and $57.16m respectively ($88.02m and $89.9m after CN adjustments). ANAO calculated the relevant amounts to be $47.1m and $50.42m ($74.75m and $79.8m after CN).

contractual purposes.[133] Adjusting the savings calculated by OASITO for this component results in the first ranked tenderer offering direct cost savings to the ATO over the five year term of $56.5 million or 10 percent (NPV $44 million). This issue is neutral in respect of post-CN savings. Notional savings after the application of CN adjustments were calculated by OASITO as $95 million or 19 percent (NPV $74.7 million). The ATO Options Committee's recommendation that the first ranked tenderer be selected as preferred tenderer was endorsed on 12 March 1999.

6.24 The ATO IT&T Services Final Evaluation Report noted that the savings estimates identified in the evaluation needed to be viewed in the context of a possible overstatement of ATO voice PABX refresh costs of $12 million.[134] ANAO noted that, as the tender did not involve an in-house bid, this approach may not be consistent with an evaluation of savings available to the Commonwealth on a like-for-like basis.

6.25 The ATO cost baseline included an amount of $13.5 million over five years for periodic replacement of PABX equipment based on age. The ATO Evaluation Report noted that, during re-pricing discussions with tenderers, it was revealed that tenderers had not included any provision for PABX replacement, as they considered it unnecessary given the age and compatibility with industry standards of the existing equipment. Tenderers had also explained that an ongoing program of equipment upgrades to maintain industry compatibility was sufficient and included in their costs.

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[133] All costs, including tax-related costs, that will be reflected in a tenderer's contracted pricing should be included in the tendered price used to calculate direct financial savings to agencies in comparison to the agency cost baseline. Under CN policy, tax-related costs included in the price tendered by private sector tenderers should then be added to agency baselines as a notional CN adjustment. However, the ATO tender evaluation excluded sales tax-related costs from the tenderers' pricing used to calculate direct pre-CN savings to the ATO. The ATO RFT required tenderers to provide pricing both inclusive and exclusive of sales tax. In its tender response, the successful tenderer advised that, based on taxation advice received, it believed it was unable to receive a sales tax exemption on hardware not used exclusively by and for Federal Government employees. Accordingly, $3.91m of sales tax-related costs were included in the sales tax-exclusive pricing provided by the tenderer. The tenderer was subsequently requested to provide pricing exclusive of all sales tax. In providing such pricing, the tenderer clearly identified that it was for evaluation purposes only and could not be offered contractually. That pricing was used to calculate savings to the ATO before the application of CN adjustments. The CN adjustment then applied added the residual sales tax costs identified by the successful tenderer to the evaluation-purpose pricing of both remaining tenderers, and to the agency cost baseline. This approach was contrary to the purpose of the CN adjustment, and to the approach identified in the Cluster 3 and Group 5 IT Services evaluation reports. In those tenders, any residual sales tax was included in tenderers' pricing for the calculation of direct savings to agencies, and then adjusted in the calculation of notional CN adjustments. The approach adopted in the ATO tender overstated the direct cost savings realisable to the ATO by $3.91m at the preferred tenderer stage, and $3.6m at the final contract stage. Although neutral from a Commonwealth perspective, those costs reduce the direct cost savings realisable by the ATO.

[134] The report also noted that the savings needed to be viewed in the context of the exclusion from savings calculations of the end of contract re-purchase of assets charges. (see Chapter 7).

6.26 On this basis, the Financial Evaluation Team argued that, for normalisation purposes, the PABX refresh should be removed from the ATO cost baseline and replaced with a $1.5 million cost for periodic upgrades. The ATO Evaluation Report noted that OASITO advice was that such an adjustment could be perceived as a breach of probity as it amounted to an adjustment of the ATO business-as-usual cost baseline to adopt a different approach proposed by a tenderer. OASITO advised ANAO that the tenderer assumed responsibility for delivering the voice solution that meets the contractual requirements (including service levels) for the agreed prices; and that the tenderer carries the risk of its assumptions regarding refresh and maintenance, or other technical assumptions that have a financial impact, proving to be wrong.

6.27 The ATO Evaluation Report also noted that, in the course of the bid process, a number of opportunities to deliver additional benefits and/or savings to the ATO were identified, some of which were related to the technical solution that an outsourcer with access to worldwide staff and research can offer. OASITO considered that, if adopted, these strategies may return additional savings in the order of $15 million. The ATO Evaluation Report noted, however, that those potential benefits must be considered in the context of the business and regulatory environment in which the ATO operates, and that realisation of some of the benefits may require modification of law, government policy and/or ATO business practices.[135]

6.28 The contracted pricing in the ATO Agreement represented an increase in costs to ATO over those identified at the preferred tenderer stage of $22.5 million (NPV $18 million), a 5 percent increase in costs. The most significant element of this increase related to the final contractual arrangement negotiated in respect of the delivery of telecommunications services.

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[135] The potential benefits identified were not included in the reported savings for a number of reasons. In some cases, the ATO declined or was unable to accept the proposed alternatives at the time of the evaluation due to various factors including a lack of technical references, incompatibility with existing government policy or pre-existing application and hardware commitments, and ATO preferences in regard to contractual arrangements. Other potential additional savings were contingent upon the realisation of particular circumstances, the outcomes of which were not known at the time of evaluation. One of those contingent savings related to a price markup of $1.1 million that could be avoided by ATO reviewing its policy to collect commercial rent where it made accommodation available to the ESP. Prior to execution of the Agreement, ATO determined that it would not require the ESP to pay rent for the use of ATO general office accommodation or the Bruce Data Centre, generating an additional $1.1 million in savings.

Telecommunications contractual structure

6.29 The ATO RFT offered tenderers two options on which they could base the telecommunications aspects of their bids.[136] Both tenderers proposed the option under which it would act as procurement agent for the services, but the ATO would contract separately with the telecommunications carriage provider. The savings identified as at selection of preferred tenderer were based upon the compliant tender offers received, and included savings for voice and data telecommunications services of $23.4 million over five years (NPV $18.3 million).

6.30 The ATO Final IT&T Services Evaluation Report, prepared in support of the selection of preferred tenderer, noted that it was ATO's strong preference to obtain telecommunications services from the prime contractor under the Services Agreement, possibly using a traditional subcontractor arrangement.[137] Following negotiation with the preferred tenderer, three options were developed for the telecommunications contractual structure.

6.31 Five days prior to execution of the Agreement, ATO formally advised OASITO that it had selected the option under which the ESP would be prime contractor for all services. Under this arrangement, the prime contractor would procure carriage services in its own name under its own contract with the carriage services provider, and bill those services to the ATO as part of a total 'bundled' service package. Additional costs arise under this structure due to the need for the prime contractor to recover a margin on the fees paid to the carriage provider, applied as a markup on service fees to ATO. The arrangement also has potential implications for the effectiveness of whole-of-Government telecommunications arrangements (see discussion below under *Whole-of-Government telecommunications requirements*).

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[136] Option A: the prime contractor provides all telecommunications services itself (in which case it must enter into a whole-of-government Head Agreement for those services); or Option B: the prime contractor procures telecommunications services from a separate supplier under whole-of-government arrangements, in which case the separate supplier must enter into a separate Head Agreement.

[137] ATO had two concerns regarding the compliant proposals from the tenderers. Firstly, due to carriage and managed voice services being provided by the telecommunications carrier under a separate contract rather than as a subcontractor, the prime contractor would not have direct legal accountability for end-to-end service. Secondly, that ATO management of two contractors with dovetailing service responsibilities could provide difficulty and increase management costs.

6.32 ATO advised OASITO that this approach minimised any risks associated with the delivery of IT&T services required to support the Government's reform agenda. ATO also expressed the view that this was consistent with the telecommunications service being provided by the 'internal service provider' and placed accountability for the delivery of end-to-end service with the prime contractor. In contrast, OASITO advised ANAO that it considers the 'separate contracts' option originally proposed by the tenderer to more closely align with the management and accountability arrangements that operated within the ATO prior to outsourcing, whereby ATO contracted directly for telecommunications carriage services, managed that relationship and carried the risk associated with integrating the services with other elements of the IT service chain.

6.33 The ATO Services Agreement executed on 31 March 1999 reflects a traditional subcontractor relationship between the prime contractor and the telecommunications carrier and, consequently, the contracted pricing incorporates the markup effect. The information provided to the Minister for Finance and Administration in support of the selection of preferred tenderer noted that negotiation of an arrangement for the provision of telecommunications services that addressed ATO's concerns regarding contractual accountability, while also meeting whole-of-Government policy requirements, remained to be completed.

6.34 OASITO advised ANAO that these increased costs to the ATO are not relevant to the calculation of the savings attributable to the compliant tenders received in response to the RFT. OASITO noted that the decision to enhance the single point of accountability for service delivery through the adoption of a different contractual arrangement to that contemplated in the tenderer's compliant offer represented an investment by the ATO in a different service delivery model that was not required by the RFT, and was not therefore included in the savings calculation.[138]

6.35 An email was provided to the Minister's office by OASITO on 26 March 1999 advising of the option ATO had elected to take up. It was noted that final pricing from the prime contractor had not yet been received, but that the price impact was at least $14 million above the

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[138] OASITO further advised that: '*the savings analysis requires a comparison of costs and prices for like services that are compliant with the RFT. Agencies are free to invest in different, more expensive services, but this investment decision cannot be taken into account in determining 'savings' for evaluation purposes. Thus, outsourcing can produce savings which are then spent by agencies on service enhancements, with a net neutral cash flow relative to the business as usual cost baseline. How agencies choose to spend the savings produced from outsourcing is a matter wholly outside the savings analysis itself.*'

evaluated solution. This was the estimate provided to the ATO by OASITO. Based on the contracted pricing, ANAO's analysis found that actual costs to the ATO for voice and data telecommunications services over the term will be $20.97 million (NPV $16.8 million) higher than those used in the savings evaluation. This represented a financial cost to the Commonwealth that was 45 percent greater than the additional costs identified by OASITO.

6.36 A final written briefing to the Minister in support of the execution of the Services Agreement and identifying the final contracted pricing for the ATO outsourcing was not prepared by OASITO.

6.37 **Finding:** The first ranked tenderer was assessed as offering savings over a five year term of $60.44 million or 10.6 percent over the agency baseline (NPV $47.1 million). The direct financial savings to the ATO were overstated by $3.91 million as the evaluation did not consider sales tax-related costs that the tenderer had advised would a component of the price bid for contractual purposes. Adjusting the savings calculated by OASITO for this component results in the first ranked tenderer offering direct cost savings to the ATO over the five year term of $56.5 million or 10 percent (NPV $44 million). This issue is neutral for post-CN savings purposes. Notional savings after the application of CN adjustments were calculated by OASITO as $95 million or 19 percent (NPV $74.7 million). The ATO Options Committee's recommendation that the first ranked tenderer be selected as preferred tenderer was endorsed on 12 March 1999.

6.38 The contracted pricing in the ATO Agreement represented an increase in costs to ATO over those identified at the preferred tenderer stage of $22.5 million (NPV $18 million), a 5 percent increase in costs. The most significant element of this increase, $20.97 million, related to the final contractual arrangement negotiated in respect of the delivery of telecommunications services under which the ATO elected for the prime contractor to fully manage the delivery of telecommunications services through a subcontract arrangement. As this was a service not envisaged in the tenderer's compliant offer, the associated costs were not included in the tender evaluation savings calculation. A final written briefing to the Minister in support of the execution of the Services Agreement and identifying the final contracted pricing for the ATO outsourcing was not prepared by OASITO.

Group 5 tender outcomes

6.39 In the Group 5 tender process, it was not until seven months after the tenders closed in August 1998 that potential savings for the Group were identified.[139] The three shortlisted tenderers were asked to review their pricing on 13 November 1998[140], and again on 4 December 1998. Tenderers were requested to provide pricing against alternatives to RFT requirements and clarification about the scope and assumptions reflected in their pricing. In December 1998, OASITO advised the Group 5 Steering Committee that it had advised all tenderers that, at that stage, there was no business case to outsource.

6.40 In January 1999, OASITO advised the agencies that analysis of the bids and agency baselines had highlighted areas where tenderers had not fully understood or had 'over-read' some agency requirements, as well as a number of areas in the agency cost baselines which required more thorough investigation.[141] On 12 February 1999, the three shortlisted tenderers were asked to respond to a revised RFT that included revisions necessary to take account of changes in requirements flowing from the October 1998 departmental arrangements and other changes since the release of the June 1998 RFT, as well as changes to service levels and other requirements agreed to by the Group agencies. Responses were received on 23 February 1999. The response provided by the successful tenderer was substantially higher than its previously provided pricing. Revised pricing received from the successful tenderer on 26 February 1999 reduced its 23 February 1999 pricing by $9.1 million, to a level comparable with its previously tendered pricing. Tenderers' responses were then the subject of further negotiation.

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139 In September 1998, OASITO had expressed concern to the Group 5 Steering Committee that it was not yet satisfied that a fair and reliable market test was being undertaken because some bids had widely variable prices while the service level regime was not reflective of service levels being actually achieved in agencies. Subsequently, the Group agencies agreed to adopt a revised service level regime. Discussions were held with each agency to again reconcile the cost baselines with the RFT. The bid of one of the tenderers excluded after the Initial Evaluation phase was the lowest of those tenders for whom major deficiencies against the cost savings sub-criteria had not yet been detected and was, at that time, $14.7 million below the Group baseline. However, the tenderer was assessed as not meeting the corporate capability and commitment to service and risk sub-elements of the threshold service and risk criteria.

140 Each of the tenderers was advised that its current price was of particular concern to the Commonwealth.

141 OASITO advised agencies that it did not consider the agency cost baselines to accurately reflect the existing service levels being achieved by agencies or the service levels being requested of tenderers. A number of the agencies did not agree with this assessment. OASITO engaged a consultant to review agency baselines and assist in updating requirements, with a number of revisions subsequently agreed between agencies and OASITO.

6.41 No further pricing offers were received from the highest-cost tenderer. Following a negotiation round with the other two remaining tenderers, revised pricing was provided by the successful tenderer on 8 March 1999. The other remaining tenderer provided its revised and final pricing on 10 March 1999. After that pricing round, the successful tenderer's pricing was the lowest by $2.9 million, but was some $7 million higher than the Group cost baseline. Further negotiations were conducted with the successful tenderer on 12 and 17 March 1999. The tenderer provided its revised and final pricing on 18 March 1999, reducing its pricing by $7 million.[142]

6.42 The successful tenderer was assessed as offering savings over the five year term of $0.96 million or about one percent of the total Group cost baseline (NPV $0.17 million). Costs against two of the Group agencies, DoCITA and DoTRS, were assessed as representing a premium over the agency cost baseline of $3.78 million or 28 percent[143] (negative NPV $3.2 million) and $2.22 million or 7.9 percent (negative NPV $1.94 million) respectively. The Group 5 IT Services Final Evaluation Report, which discussed savings in undiscounted terms, reported that the preferred tenderer would generate modest savings of almost $1 million over five years. Notional savings after the application of CN adjustments, as calculated by OASITO, were $8.3 million or about 8 percent (NPV $6 million).

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[142] Final agreement between OASITO and Group 5 agencies on two items that affected savings was not reached until shortly before the conclusion of the Group 5 evaluation. The two items were the expected Group 5 contract management costs and the proportion of agency accommodation able to be released for other purposes. The effect of the agreement increased nominal savings for the Group over five years by $936,000 compared with a calculation based on earlier cost estimates made by Group 5 agencies for these items. The Group 5 CMO noted that costs for these elements had not been finally agreed with OASITO until this stage of the evaluation and there had been considerable debate prior to this.

[143] OASITO expressed the view that, compared to applying current resource levels to IT within DoCITA over the next five years, DoCITA will receive guaranteed and high quality service, improved security and disaster recovery as a result of the outsourcing. The Group 5 Final Evaluation Report noted that analysis had highlighted that the cost baseline for DoCITA was relatively low both in comparison with IT costs per user for other agencies in the Group and in comparison with tendered prices. In February 2000, DoCITA advised ANAO that, at the time its cost model was calculated, the changes in departmental arrangements following the 1998 Federal election had not been fully implemented to the degree that it was not yet supporting the data networks for the agencies which had been added to the portfolio. In addition, a number of projects and reviews were postponed due to the imminent outsourcing. DoCITA advised that it made an allowance in the cost model for supporting the new networks and reviews, based on its experience of supporting the '*very economical*' Banyan environment. However, DoCITA advised that reality had shown that supporting the new NT operating environments was more costly than the allowance used in the cost model and that, subsequent to the execution of the Group 5 Services Agreement, it revised its projected baseline costs upwards by $2 million over the five years. This 'revised' cost model was initiated to provide an indicative guide for producing actual cost comparisons in the future.

6.43 The recommendation of the Group 5 Options Committee that the first-ranked tenderer be selected as preferred tenderer was endorsed on 25 March 1999. Based on final contracted pricing, the reported pre-competitive neutrality savings were slightly improved to $2.4 million (NPV $1.3 million) or about 2 percent of the total Group baseline. A written briefing confirming the outcome of final contract negotiations with the preferred tenderer was not provided to the Minister for Finance and Administration prior to the execution of the Services Agreement.

6.44 Selection of the successful tenderer was contingent upon the board of the majority member of the joint venture forming the company agreeing to become a party to the contract, and to be jointly and severally liable for the delivery of the services.[144] The Group 5 Services Agreement required the successful tenderer to provide, on or before 31 May 1999, a deed of performance executed by it and its majority joint venture parent company. Execution of the Deed of Performance was finalised by the Commonwealth parties on 6 July 1999, 36 days after the required date and 6 days after the commencement of the Services Agreement. In August 1999, the Group 5 Contract Management Office (Group 5 CMO) advised the ANAO that the Deed of Performance was the main form of protection for the Group in the event of a substantial failure by the ESP. The Group 5 CMO advised that the Group believed that the Deed offered good protection to the Group in such situations and had concluded that an unconditional financial undertaking was not required from the ESP at this time.

[144] The successful tenderer is a relatively new joint venture company capitalised at $2000. At the time of selection, its three parent shareholders were substantial companies. The tenderer had advised during the evaluation that it would not be able to provide a parent company performance guarantee. As a new company, it did not provide financial details with the exception of projected earnings. In those circumstances, the Corporate Evaluation Team had determined that the successful tenderer should be required to provide a financial undertaking. Although the cost of this undertaking for the first year was estimated at $240,000, this amount was not considered in the business case analysis. The Group 5 Steering Committee considered the risk associated with the non-availability of a Parent Guarantee to be acceptable in the circumstances. OASITO advised the Minister for Finance and Administration that it viewed this risk with concern and had raised the issue with the senior joint venture partner. At the time of selection of Preferred Tenderer, OASITO reported that the joint venture partner had agreed, subject to Board approval, to become a party to the contract and be jointly and severally liable with the ESP for delivery of services.

6.45 **Finding:** In the Group 5 tender, it was not until seven months after the tenders closed that potential savings for the Group were identified. The successful tenderer was assessed as offering savings over the five year term of $0.96 million or about one percent of the total Group cost baseline (NPV $0.17 million). Notional savings after the application of CN adjustments, as calculated by OASITO, were $8.3 million or about 8 percent (NPV $6 million). Based on final contracted pricing, the reported pre-CN savings were slightly improved to $2.4 million or about 2 percent (NPV $1.3 million). A written briefing confirming the outcome of final contract negotiations with the preferred tenderer was not provided to the Minister for Finance and Administration prior to the execution of the Services Agreement.

Whole-of-Government telecommunications requirements

6.46 A significant part of the value of services offered under the tenders reviewed related to telecommunications costs, including carriage services. Voice telecommunications services were incorporated into the IT outsourcing tender process by agencies on an optional basis. In the 1996-97 Budget context, the Government required all Commonwealth departments and budget-dependent agencies to use mandated whole-of-Government arrangements for telecommunications carriage services.

6.47 Under the whole-of-Government telecommunications arrangements (WOGTA), telecommunications carriers and carriage service providers are required to negotiate whole-of-Government Head Agreements with the Commonwealth. Those Agreements provide a purchasing framework in which the Commonwealth is recognised as a single purchaser of telecommunications services, such that pricing provided by a carrier or carriage service provider to one agency is to be available to other agencies. This is intended to enable individual agencies to access pricing benefits arising from the purchasing power of the total Commonwealth demand for such services. Commonwealth agencies are required to procure telecommunications services in accordance WOGTA.

6.48 The Office for Government Online (OGO) is responsible for whole-of-Government telecommunications policy and for the negotiation of Head Agreements with carriers and carriage service providers. Each Head Agreement includes reporting requirements under which the firm is required to provide OGO with details of its pricing with Commonwealth agency customers. This enables OGO to negotiate whole-of-Government rates with carriers and carriage service providers, and to provide advice to agencies regarding the competitiveness of offered pricing. The telecommunications services provided under the IT Initiative are required to be supplied in accordance with the whole-of-Government telecommunications policy.

6.49 The savings obtained from group tendering under the IT Initiative have outstripped those previously obtained by individual agencies through whole-of-Government telecommunications pricing. The aggregated tendering processes undertaken in the context of the IT Initiative have produced significant pricing improvements over existing agency costs. However, there has been some diminution in the capacity of the Commonwealth to obtain those pricing improvements over all agencies as envisaged under WOGTA. Tenderers are required to agree that tendered pricing will be made available to agencies with similar needs to those included in a particular tender. Careful management will be required to ensure that this 'picket fencing' does not result in short-term gains for specific agencies, but a reduction in overall long-term value to the Commonwealth.

6.50 Another aspect of the interaction between WOGTA and the outsourcing of IT infrastructure that will require careful management to ensure the two initiatives remain consistent and complementary is the nature of the arrangements entered into for the provision of telecommunications services by the ESP in the context of a comprehensive IT&T outsourcing agreement.

6.51 Under the ATO Agreement, the ESP provides telecommunications services to the ATO under the Services Agreement, rather than procuring them as the Commonwealth's agent under a separate whole-of-Government agreement. The ATO RFT required that, where such arrangements were proposed, the successful tenderer (or its telecommunications subcontractor) would be required to enter into a separate Head Agreement with OGIT (now OGO) making the tendered offering available to Commonwealth agencies with similar needs. This was to give effect to the WOGTA. The RFT also stipulated that the Head Agreement, with associated pricing schedules and reporting requirements, must be finalised and executed before the Services Agreement was signed unless prior agreement was reached with OGO. Agreement on the ATO telecommunications arrangement was not reached with OGO prior to the ATO Services Agreement being executed.

6.52 The ATO ESP did not have a whole-of-Government Head Agreement with OGO and, under the ATO Agreement, is not required to enter into one. The ESP's subcontractor for telecommunications carriage services does have an existing Head Agreement. However, although the services are for the ultimate use of the ATO, it appears that it is the ESP that is the identified customer of the account of services provided by the subcontractor. Under the arrangement negotiated by the ATO and OASITO, the ESP procures carriage services in its own name under its own contract with the carriage services provider, and bills those services to the ATO as part of a total 'bundled' service package.

6.53 As the ESP is not a Commonwealth agency customer of the subcontractor for the purposes of the Head Agreement, it is unclear whether the Commonwealth has any standing to require the subcontractor to provide it with information about the pricing of those services to support analysis of whole-of-Government pricing. It is also not clear that the pricing negotiated by the ESP is required to be passed onto other Commonwealth agencies where appropriate,[145] or how this arrangement may affect the capacity of the ATO to access whole-of-Government rates for telecommunications services required during the term.

6.54 Another potential impact of such arrangements is that the relevant services are effectively removed from the pool of service volume on which the pricing discounts available to agencies under whole-of-Government rates are based. This may result in a dilution of the benefits the Commonwealth was seeking to obtain through WOGTA.

6.55 As telecommunications requirements and services evolve, outsourced providers of IT services are increasingly providing applications and value-added, bundled or managed services that include a telecommunications carriage component. In that scenario, the ESP may be considered a carriage service provider for the purposes of WOGTA. The provision of such services is likely to increase over the course of long-term IT&T outsourcing arrangements as new requirements are identified.

6.56 However, where the ESP does not have a Head Agreement with the Commonwealth in its own right, the telecommunications component may not be procured and reported under WOGTA. As a result, the transparency of the pricing underlying those bundled or managed services to the Commonwealth may be diminished. This would, in turn, diminish the capacity of OGO to ensure pricing offered to agencies is competitive with whole-of-Government rates.

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[145] Where the ESP has a Head Agreement, or the ESP operate as the agent of the Commonwealth in procuring the services, and the account is in the name of the Commonwealth, the pricing provided to the relevant agencies can become the new whole-of-government price for access by other agencies where it is better than prevailing rates. OGO advised ANAO that, in renegotiating the Head Agreement with the subcontractor, it is seeking to clarify that the reporting requirements apply in situations in which a Commonwealth agency is the ultimate customer for the services.

6.57 ANAO considers that it would be of benefit to the Commonwealth for future IT outsourcing agreements to require that relevant services be provided to agencies in accordance with WOGTA, including that services must be procured under a whole-of-Government Head Agreement supported by reporting arrangements. Where appropriate, this may include a requirement that the ESP negotiate a Head Agreement with OGO where it acts as a telecommunications carriage service provider. This will assist in ensuring that the operation of IT outsourcing agreements is, and remains, consistent with the objectives of the whole-of-Government arrangements for telecommunications.

Telecommunications carriage savings

6.58 Projecting telecommunications carriage costs over a five year period is difficult given that the market for those services is undergoing significant change as to both services provided and pricing structures. In each of the Cluster 3, ATO and Group 5 RFTs, the Commonwealth recognised the need to be able to take advantage of emerging competition and the rapid pace of change in the telecommunications market. The initial term proposed for telecommunications carriage services was considerably shorter than the initial five year term proposed for the overall Agreement. Tenderers were asked to propose pricing for those shorter terms, and pricing options for the remaining term of the IT services Agreement.

6.59 Tender evaluations are normally conducted for the period of the initial contractual commitment under consideration as this is the period that provides greatest certainty in regard to projected financial outcomes. In the Cluster 3 evaluation, the comparative savings offered by tenderers' bids over the projected agency baseline costs were evaluated for the initial two and three year contractual terms identified for data and voice services respectively. However, in the ATO and Group 5 tenders, agency baselines included five-year projections of telecommunications carriage costs. These essentially consisted of straight-line extrapolations of historical expenditure.[146] Tenderers were required to tender prices for carriage services for two years, and to provide options exercisable by the Commonwealth for the remaining years of the term.

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146 For three of the four relevant agencies in Group 5, the projected telecommunications carriage costs over the five years to 2003-04 was a straight-line extrapolation of costs identified in the cost model for 1997-98. The fourth agency, DoCITA, incorporated a growth factor in its forward projections. The ATO cost model also shows a straight-line extrapolation of telecommunications carriage costs from 1997-98 to 2003-04.

6.60 Savings were identified in the ATO and Group 5 tenders against telecommunications carriage costs over a five year period, with the second-year pricing offered by each tenderer extrapolated to the remaining three years for tender evaluation purposes. OASITO advised ANAO that the reporting assumption was changed after the Cluster 3 tender as it was concluded that failure to include a five-year view of telecommunications benefits of group outsourcing would understate the benefits of the outsourcing program and fail to reflect the full five year cost of the in-scope IT services.[147]

6.61 ANAO notes that the overall evaluation for each tender was conducted for a five-year period, being the initial term of the Agreement, rather than for the additional period for which extension options are exercisable by the Commonwealth. Under the ATO Agreement, the contractual term for telecommunications carriage services is two years, with options for seven one-yearly extensions. In the case of Group 5, the successful tenderer is contracted to deliver telecommunications carriage services for five years, but the carriage pricing is for an initial two year term. The Agreement sets out a process under which the prime contractor is to undertake market testing of those services every two years. Under both Agreements, the Commonwealth has the option of continuing with the initial pricing for the remainder of the five-year term, but has recognised that shorter decision time-frames are appropriate in the current telecommunications environment.

6.62 The assumption employed in the ATO and Group 5 tenders was that the proportional, comparative savings offered by each tenderer over the agency baseline in year two of the Agreement would remain constant for a further three years. Given the significant uncertainty attaching to a five-year projection of agency telecommunications carriage costs in the current market, a more conservative approach to the identification of savings arising from those services may have been appropriate. Such an approach could, at a minimum, involve providing the decision-maker with cost savings estimates based on both the five-year and two-year view for telecommunications carriage services or, as in the Cluster 3 tender, reporting savings for the term of the Commonwealth's initial contractual commitment.

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[147] ANAO notes that ATO is a single agency group.

6.63 **Finding:** The savings obtained from group tendering under the IT Initiative have outstripped those previously obtained by individual agencies through whole-of-Government telecommunications pricing. The specific tendering processes undertaken in the context of the IT Initiative have produced significant pricing improvements over existing agency costs. However, there has been some diminution in the capacity of the Commonwealth to obtain those pricing improvements over all agencies as envisaged under the whole-of-Government telecommunications arrangements (WOGTA).

6.64 ANAO considers that it would be of benefit to the Commonwealth for future IT outsourcing agreements to require that relevant services be provided to agencies in accordance with WOGTA, including that services must be procured under a whole-of-Government Head Agreement supported by appropriate reporting arrangements. Where appropriate, this may include a requirement that the ESP negotiate a Head Agreement with OGO where it acts as a telecommunications carriage service provider. This will assist in ensuring that the operation of IT outsourcing agreements is, and remains, consistent with the objectives of the WOGTA. Given the significant uncertainty attaching to a five-year projection of agency telecommunications carriage costs in the current market, a more conservative approach to the identification of savings arising from those services to that taken in the ATO and Group 5 tenders may have been appropriate.

Recommendation No. 11

6.65 ANAO *recommends* that relevant agencies ensure that future IT outsourcing agreements complement the Government's whole-of-Government telecommunication policy by stipulating a requirement that:

a) relevant services be provided to agencies in accordance with whole-of-Government telecommunications arrangements, including that services must be procured under a whole-of-Government Head Agreement supported by appropriate reporting arrangements; and

b) all telecommunications services be procured in the name of the Commonwealth unless otherwise agreed in writing by the Office for Government Online.

6.66 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response***:
  - Part (a): **Agree.** Whole of Government telecommunications requirements are defined by Office for Government Online (OGO) in consultation with OASITO. OGO reviews each RFT for IT&T

services prior to release to ensure consistency with whole-of-Government telecommunications requirements. ANAO's recommendation will be implemented to the extent it is consistent with whole-of-government requirements as advised by OGO.

- Part (b): **Agree with qualification.** The current tendering rules permit tenderers to propose telecommunications services under two alternative models, consistent with whole-of-Government telecommunications requirements as advised by OGO.

7. Agency Cost Savings Evaluation

This paper discusses the evaluation of the cost savings offered by tenderers in the Cluster 3, ATO and Group 5 tenders over the projected agency cost baselines.

Analytical framework

7.1 In each of the tenders reviewed the evaluation criteria set out in the respective RFT provided that the financial evaluation would play a central role in determining the outcome of the tender. It would provide the relevant Ministers with the information necessary to determine whether the identified precondition for the awarding of a contract of substantial cost savings had been achieved and, if so, which tenderer offered the best financial outcome.

7.2 In the absence of in-house bids, the role of the financial evaluation was to provide the decision-maker with the information necessary to determine whether the relevant agencies would obtain financial benefit from making the change to outsourcing their IT infrastructure, as opposed to continuing with internal service delivery. Therefore, the change to outsourcing represented the 'change case'. Where that 'change case' did not satisfy specified preconditions, the RFTs in the tenders reviewed provided that an outsourcing contract would not be awarded.

7.3 The first order issue for the Commonwealth was the establishment of the initial base case. That involves the quantification of the incremental costs that will be affected in the five-year period of the evaluation if the Commonwealth proceeds to outsource the IT services under a long-term contract, compared to continuing with agency in-house provision. OASITO advised ANAO that it had adopted a financial evaluation methodology which assessed the expected financial effect of outsourcing on an agency cash flow basis. OASITO further advised that the model used was not a wider economic model and therefore does not attempt to capture the broader economic benefits of outsourcing to the Commonwealth.

7.4 The Cluster 3, DEETYA/EN, ATO and Group 5 tender evaluations adopted a financial evaluation approach in which the estimated annual cash costs of continuing agency provision of the relevant services (being operating costs, labour costs and capital outlays for upgrades or refresh of capital equipment) were compared with the projected annual cash costs of an alternative system of delivery by a private sector provider over a five year period (being transitional costs and service charges for equipment and services provided). As noted, OASITO advised that NPV analysis was only applied to those cash costs to test the sensitivity as to whether tenderers' rankings change in NPV terms using different discount rates.

7.5 ANAO's analysis of the financial evaluation methodology applied in the tenders reviewed, and of the implications of adjustments identified in the audit, is based on the quantified financial information determined in the respective evaluation processes. The analysis presents both the cash (or nominal) savings and NPV savings (the latter brings nominal savings back to a common measurement point allowing for the five year period of analysis).

7.6 In each tender, the financial evaluation was undertaken in two parts. The first involved comparing the prices bid by tenderers to the cost baseline established for each agency. This part of the evaluation was the focus of the majority of the effort and resources committed to the financial evaluations. The outcome was the identification of the direct financial savings expected to be realised by each agency and the group as a whole through outsourcing the tendered services (compared to continued internal delivery), together with an assessment of the acceptability of tenderers' pricing proposals.[148]

7.7 After the savings in agency cash outlays attributable to each tenderer had been calculated, notional competitive neutrality (CN) adjustments were added to the agency cost baselines. The final evaluation reports prepared in respect of each tender then identified projected financial savings, as well as notional post-CN savings. The savings after the adjustment for the application of CN are notional in that they provide a measure of the savings if resource allocation distortions arising out of public ownership were eliminated.[149] ANAO's analysis of the financial evaluations undertaken in each tender reviewed considers firstly the methodology employed in determining the direct financial savings projected to be realised by the relevant agencies through the change to outsourcing. The methodology used in calculating the notional CN adjustments to agency costs in each tender is then considered in the second part of this chapter.

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148 In terms of the extent to which they would provide continued market competitiveness, flexibility, predictability and access to gain sharing over the term.

149 ANAO was unable to verify the accuracy of the CN adjustments calculated for each of the tenders reviewed due to the absence of complete working papers supporting the calculation of those adjustments.

Agency cost savings

7.8 ANAO notes that the financial evaluation methodology adopted in the Cluster 3, ATO and Group 5 tender evaluations did not capture all of the relevant costs. In particular, the methodology applied did not appropriately recognise end-of-period agency assets, and the costs arising from the Commonwealth's obligations in respect to the assets expected to be used by tenderers in delivering the services.

Agency end-of-period asset values

7.9 In each tender the direct financial savings expected to be realised by agencies through outsourcing were identified by comparing projected annual agency cash costs over the five year evaluation period with the estimated annual cash flows associated with the each tenderers' bid. However, the agency and tenderer cash flows were constructed on two quite distinct bases. A significant component of the costs associated with the business-as-usual case of continued in-house delivery related to the periodic acquisition of new or replacement capital equipment.[150] By their nature, those acquisitions were represented in agency baseline costs by relatively large, sporadic cash outlays. In contrast, tenderers' pricing proposals were based upon constant, lease-based payments for the use by agencies of equipment supplied by the tenderer.

7.10 Therefore, the cash flows being compared reflected the procurement of assets with unequal lives.[151] The residual value of agencies' assets at the end of the five years represented future service potential that lay outside the timeframe of the OASITO evaluation analysis, but which was accrued through the cash flows included in the evaluation. OASITO's financial evaluation took account of projected annual cash inflows and outflows, with the result that the cost of asset purchases by agencies was charged in its entirety in the year in which it was projected to be paid. No financial adjustment was made in OASITO's analysis for the value of agency assets remaining at the end of the evaluation period.

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150 Expenditure on capital purchase accounted for 15 percent of Cluster 3 baseline costs over five years, 18 percent for ATO and 35 percent for Group 5.

151 In some cases, agencies also proposed to procure equipment during the evaluation period through leasing. In those cases, the financial evaluation appropriately incorporated a direct comparison between lease costs in the two sets of cash flows. However, leased equipment is not reflected in agencies' projected asset values at the end of the evaluation period, and therefore is not relevant to the analysis undertaken by ANAO regarding the treatment of agency end-of-period assets in the financial evaluation.

7.11 In order to capture the true financial value of entering into an outsourcing arrangement in a financial evaluation covering a number of years, the normal approach is to apply DCF analysis using NPV. For each available option, the cash flows expected during the evaluation period, and the residual asset values that provide service potential after the end of the evaluation period, are discounted to a present value. In such analysis, the future stream of benefits associated with terminal assets will normally be valued at fair market value (FMV)[152] or at deprival value[153], as opposed to accounting values such as net book value (NBV).[154] The various options available are then compared to identify the option with the highest NPV. This provides a sound basis for decision-making by adjusting the period-based analysis for the unequal cash flows and asset lives in the options under consideration.

7.12 For example, where the agency cost baseline includes an expectation that the agency will spend say, $9 million, in the final year of the evaluation period to purchase assets with a three-year economic life, the agency cost baseline would be inappropriately inflated as against the tenderers' lease prices (as illustrated in Figure 7.1), unless the two years of service potential yet to be derived from those assets at the end of the evaluation period was incorporated in the financial evaluation in the form of residual value.

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[152] 'Fair Value' is defined in Statement of Accounting Standard AAS21 *Accounting for the Acquisition of Assets (including Business Entities)* as the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

[153] Rather than focusing on market price, the deprival method values assets in terms of the services or benefits they provide. In short, if an agency were deprived of an asset, what would be the value of the service or benefits the agency gives up as a result? If an agency would replace the asset if deprived of it, the asset's value is the cost of replacing the service or benefit, using current day prices and technology. If the agency would not replace the asset, it is valued at market selling price.

[154] Net book value equals historical cost less accumulated depreciation.

Figure 7.1

Illustration of overstatement of realisable savings where future service potential of agency assets not recognised in evaluation period

	Evaluation period cash outlays		*Cash outlays for asset use beyond evaluation period*	
	Yr 5		*Yr 6*	*Yr 7*
Cost of equipment with 3 year useful life	$9m			
Agency equipment purchase (cash outlays in business-as-usual costs)		$9m	$0m	$0m
Agency equipment lease (cash outlays to ESP under outsourcing)		$3m	$3m	$3m
OASITO reported savings from outsourcing		$6m	n/a	n/a
Note 1: Financing costs for equipment leasing excluded for illustration purposes				

Source: ANAO analysis

7.13 The financial evaluation approach adopted in the Cluster 3, ATO and Group 5 tenders was not in accordance with normal commercial practice as the end-of-period value of agency assets under the business-as-usual case was not included in the evaluation. The OASITO Guidelines on Financial Evaluation issued in respect of each tender did not include provision for recognition in the evaluation of the residual value of agency assets that had future service potential at the end of the evaluation period.[155] Consequently, the direct cost savings from outsourcing achievable by agencies, in comparison to retaining the existing internal delivery of the services, were overstated and the true financial value to the Commonwealth of entering into the outsourcing arrangement was not revealed by the financial evaluation undertaken.

7.14 ANAO analysed the change to the direct agency savings reported in the Cluster 3, ATO and Group 5 financial evaluations that would have accrued from attributing an estimate of FMV to the agency assets expected to be held at the end of the evaluation period. In view of the high degree of obsolescence attributable to IT assets, ANAO's analysis was based on the assumption that fair market values would only represent half of NBV. Including an estimate of FMV of end-of-period agency assets on that basis in the direct agency savings reported at the time of selection of preferred tenderer results in:

- a 6 percent reduction in reported direct agency savings for Cluster 3

155 OASITO advised ANAO that the evaluation of potential savings in the 1997 OGIT/DOF Evaluation included no end-of-term adjustments for asset values. OASITO also advised that all of the IT outsourcing evaluations conducted outside of the IT Initiative process had excluded end of term asset values from the financial evaluation.

from $62.03 million (NPV $49.94 million) to $58.2 million (NPV $47.27 million); and

- a 31 percent reduction in the reported direct savings to the ATO from $60.44 million[156] (NPV $47.1 million) to $41.68 million (NPV $34.33 million).

7.15 In the case of Group 5 agencies, including the estimated FMV of end-of-period agency assets results in the project yielding a negative value of $4.53 million (negative NPV $3.57 million) at the preferred tenderer stage, representing a cost to the Group agencies from outsourcing rather than a saving. There was a small improvement in pricing for Group 5 between the selection of preferred tenderer and the final contract, which results in a reduced negative value of $3.1 million (negative NPV $2.41 million) after application of the end-of-period asset adjustment.

7.16 **Finding:** The true financial value to the Commonwealth of entering into the outsourcing arrangement was not revealed by the cash financial evaluations undertaken in the tenders reviewed in this audit. The OASITO Guidelines on Financial Evaluation issued in respect of each tender did not include provision for recognition in the evaluation of the residual value of agency assets at the end of the evaluation period. Consequently, the direct financial savings from outsourcing achievable by agencies, in comparison to retaining the existing internal delivery of the services, were overstated. In the case of Group 5 agencies, including an estimate of FMV of end-of-period agency assets at 50 percent of NBV results in the project yielding a negative value of $4.53 million (negative NPV $3.57 million) at the preferred tenderer stage, representing a cost to the Group agencies rather than a saving. There was a small improvement in pricing for Group 5 between the selection of preferred tenderer and final contract, which results in a reduced negative value of $3.1 million (negative NPV $2.41 million) after application of the end-of-period asset adjustment. Inclusion of the FMV of end-of-period agency assets for the ATO tender results in reported agency savings being reduced by about one-third, while on the Cluster 3 tender the adjustment was marginal.

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156 As noted in Chapter 6, the direct cost savings to the ATO reported in the financial evaluation were overstated by $3.91m at preferred tenderer stage, and $3.6m at final contract stage, as the evaluation did not consider sales tax-related costs included in the pricing tendered by the successful tenderer for contractual purposes. The effect on the post-CN savings as calculated by OASITO is neutral.

Recommendation No. 12

7.17 ANAO *recommends* that, in order for the evaluation to identify the true financial value to the Commonwealth of future IT outsourcing tenders, relevant agencies include, at a minimum, the estimated fair market value of agency residual assets that provide service potential beyond the evaluation period.

7.18 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response:*** **Disagree.** The methodology adopted for the implementation of the IT Outsourcing Initiative does not include this residual asset value. This methodology is consistent with independent expert advice obtained by OASITO and applicable Government policy, although some agencies have noted an alternative approach.

7.19 ***ANAO comment:*** ANAO considers that this is a methodological issue associated with determining the financial value to the Commonwealth of adopting an alternative service delivery method. Accordingly, the analysis presented to the decision maker should capture the future service potential available to the Commonwealth from agencies' assets at the end of the evaluation period. No financial adjustment was made in OASITO's analysis for the value of agencies' assets remaining at the end of the evaluation period. The implication of this is that the direct cost savings from outsourcing achievable by agencies were overstated in the evaluation report presented to the decision maker.

Commonwealth capital risk on ESP assets

7.20 The Cluster 3, ATO and Group 5 Agreements cover the provision to agencies of a range of IT&T services and associated equipment. Under each Agreement, the ESP is responsible for providing the IT and telecommunications infrastructure equipment needed to deliver the tendered services. Significant parts of that equipment, such as desktop equipment, are dedicated to the delivery of the services and are leased to the agencies for their use during the term of the Agreement. In each case, the Commonwealth has substantially underwritten the ESP's capital risk on such equipment.

7.21 Under the Cluster 3 and ATO Agreements, the Commonwealth bears the capital risk for ESP-owned, dedicated assets that become surplus to the ESP's requirements. This may be due to the removal of services from scope by agencies, or through the termination or expiration of the Agreement. The Commonwealth has contracted to keep the ESP 'whole' in respect of its capital investment in dedicated assets no longer required in that, where the ESP cannot redeploy the equipment, the Commonwealth has agreed to pay the ESP any shortfall between the equipment's NBV and the proceeds from its sale. In each case, the agencies have the option to purchase these assets from the ESP at the end of the term or on termination at their net book value.

7.22 Similarly, the ESP's capital risk under the Group 5 Agreement is underwritten in that, in normal circumstances, the Commonwealth has agreed to pay the ESP the difference between the wholesale FMV of items of desktop and local area network (LAN) equipment and the total of all outstanding lease payments (capital and financing costs) on an item of equipment where the three-year lease is terminated early, or upon expiration of the outsourcing Agreement. The Commonwealth's obligation in respect of other surplus Group 5 equipment that the ESP cannot redeploy is to pay the ESP any shortfall between its NBV and the proceeds of sale received by the ESP. Group 5 agencies also have the option of buying dedicated assets from the ESP at their NBV, or having assets leased by the ESP from a third party assigned to them.

Finance leases

7.23 Australian Accounting Standard 17 (AAS 17) defines an operating lease as a lease under which the lessor effectively retains substantially all the risks and benefits incident to ownership of the leased asset. Where substantially all the risks and benefits pass from the lessor to the lessee, the lease is classified as a finance lease, regardless of whether legal ownership is eventually transferred or not. An entity that enters into a finance lease for an asset is required to bring this onto its Balance Sheet as it is the economic equivalent of borrowing to acquire the asset. Accordingly, Commonwealth agencies that enter into finance leases are required to record both the asset and the liability to pay the lease payments on their Balance Sheet.

7.24 AAS17 provides guidelines to assist in determining whether substantially all the risks and benefits of ownership have passed to the lessee or not.[157] Ultimately, the classification of a lease depends upon its economic substance, rather than its form. ANAO analysed the contractual

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[157] The effective passing of substantially all the risks and benefits of ownership is normally assumed where the following criteria are satisfied: 1) the lease in non-cancellable; and 2) either one or both of the following tests is met: (a) The lease term is for 75 percent or more of the economic life of the asset; or (b) at the beginning of the lease term, the present value of the minimum lease payments equals or exceeds 90 percent of the fair value of the asset. A non-cancellable lease is defined as a lease which: (a) can be cancelled only with the permission of the lessor or upon the occurrence of some remote contingency; or (b) the lessee, upon cancellation, is committed to enter into a further lease for the same or equivalent asset with the same lessor or a party related to the lessor; or (c) provides that the lessee, upon cancellation, incurs a penalty of a magnitude expected to discourage cancellation in normal circumstances.

arrangements in the Cluster 3, ATO and Group 5 Agreements for dedicated equipment leased to agencies by the ESP in light of the guidelines set out in AAS 17. For example, an analysis of the Group 5 leasing arrangements in respect of desktop and LAN equipment is set out in Figure 7.2. That analysis supports the treatment of the arrangement as a finance lease. The Cluster 3 and ATO Agreements reflect many of the same essential characteristics as those identified in the Group 5 Agreement for dedicated equipment provided by the ESP and are considered to also involve finance leases.[158]

Figure 7.2

Analysis of Group 5 desktop & LAN equipment leasing arrangements

Background

The Group 5 Agreement involves the provision of IT and telecommunications equipment, as well as a substantial level of services associated with their operation and maintenance. Monthly rental charges for desktop & LAN equipment alone represent approximately 20 percent of total projected service charges over five years, and are therefore material in comparison to the value of the expected payments for the service component.

Test 1 Is the lease non-cancellable?

Where, for convenience, the Group terminates the Agreement or removes services from scope, it must pay specified termination charges, together with charges for surplus equipment, software and third party agreements. Where the lease on an item of desktop/LAN equipment is terminated before the equipment is due to be refreshed (or where the Agreement expires), and the ESP cannot redeploy the item within the Group, the Group must pay any shortfall between the total of outstanding lease payments for the item and its wholesale fair market value. Because the payments for terminating a desktop lease in normal circumstances are linked to the value of the remaining lease payments, the Group is effectively guaranteeing any outstanding payments to the ESP. This indicates that the Agreement is non-cancellable and, as such, this criterion of a finance lease is met.

Test 2 Is the lease term for 75 percent or more of the economic life of the leased asset?

The initial term of the Agreement is five years, with an option to extend for another two years. The Agreement requires the ESP to replace desktop equipment in accordance with a three year refreshment cycle or as otherwise agreed with the Group, and indicates that the useful life of desktop and LAN assets is 3 years. On that basis, the lease term for desktop and LAN equipment would satisfy this criterion of a finance lease.

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[158] Finance Circular 1993-14 advised agencies that, although finance leases would normally not involve a borrowing of money by the lessee from the lessor, it is possible that some leasing arrangements would involve a borrowing of money as they could involve a notional advance of money from the lessor to the lessee to enable the particular assets to be purchased. Agencies were advised to seek legal advice if there is doubt about whether a particular leasing arrangement would involve a notional loan of money from the lessor to the lessee. Section 37 of the *Financial Management and Accountability Act (1987)* provides that an agreement for the borrowing of money by the Commonwealth is of no effect unless the borrowing is authorised by an Act. For this purpose, borrowing includes obtaining an advance on overdraft.

Test 3 Is the present value of the minimum lease payments equal to or more than 90 percent of the fair value of the assets at the inception of the lease?

Minimum lease payments include rental payments over the lease term, as well as the amount of any guaranteed residual value[159] and bargain purchase option.[160] Where there is a guaranteed residual value or bargain purchase option, the present value of the minimum lease payments will always equal the fair value of the leased assets at the beginning of the lease. If the Group 5 Agreement expires, the Group removes a platform of services or the lease on item of desktop equipment is terminated early, the Group is obliged to reimburse the ESP for the difference between all outstanding lease payments and the wholesale fair market value for equipment it cannot redeploy within the Group. The Group agencies also have the option to purchase equipment at written down book value or take over equipment leases, software licences and other third party arrangements. As such, this criterion of a finance lease is met.

Test 4 Economic substance

Under the Group 5 Agreement, the ESP appears to bear a number of the risks and benefits of ownership of the leased assets, including the risks of unsatisfactory performance of the assets and their destruction, damage or condemnation; and the benefits of ability to derive income from the assets. Some benefits, such as ability to sell at will and to improve or change appear to be shared between the ESP and the Group. However, the Agreement provides that the Group will retain control over all equipment used exclusively for the provision of services, and that the Group guarantees the total lease payments on each item of desktop/LAN equipment on expiration of the Agreement or where the equipment becomes surplus to the needs of the Group. On that basis, the economic substance of the transaction is that the Group bears all the risks associated with the decline in residual value of the assets below fair market value, idle capacity and obsolescence. These are the most significant risks of ownership.

ANAO conclusion

The Group 5 Agreement is a finance lease rather than an operating lease.

Source: ANAO analysis of Group 5 Agreement for IT&T Services and Industry Development

7.25 ANAO considers that, in framing RFTs for IT outsourcing tenders, and in the financial evaluation undertaken, there needs to be a proper assessment of the financial exposures of the Commonwealth arising from its contractual obligations in respect to tenderers' assets used in the delivery of the services. In the tenders reviewed, OASITO did not obtain appropriate specialist advice, prior to concluding the contract negotiations and financial evaluation, in order to determine the economic substance of the equipment leasing transactions. In the tenders reviewed by ANAO, the Minister for Finance and Administration was not informed that the economic substance of the equipment leases entered into with the ESP represented finance leases.

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159 *Guaranteed residual value* means that part of the residual value which is guaranteed by the lessee or a related party (the guarantee amount being the maximum amount that could, in any event, become payable). (para 21.1 of AAS 17).

160 *Bargain purchase option* means a provision of a lease which allows the lessee to purchase the leased asset for a price which, in relation to the likely fair value of the asset at the date the option becomes exercisable, is low enough to make the exercise of the option appear, at the inception of the lease, to be reasonably assured (para 21.1 of AAS 17).

7.26 The implications of this is that the Commonwealth has incurred the risks of asset ownership (where the intention was that those risks would be transferred to the successful tenderer), but has not taken account of those risks in the tender evaluation. A similar issue was discussed by ANAO in the performance audit report on the DASFLEET sale where the lease arrangement constituted a financing transaction with the ownership risks retained by the Commonwealth despite the apparent asset sale.[161]

7.27 The August 2000 DOFA whole-of-government response to the proposed audit report stated that:

> *DOFA does not agree with the ANAO's contention that the service agreements contain embedded finance leases. Together with OASITO and some agencies, DOFA has obtained expert advice on this issue from a number of leading accounting firms, a law firm and a specialist leasing firm. All of these advisers have concluded that the service agreements do not contain embedded finance leases. Based on this advice, DOFA has advised the agencies that on balance, these service agreements do not inherently give rise to embedded finance leases. The Australian Bureau of Statistics has indicated that it will follow this treatment for Government Finance Statistics purposes.*

7.28 **ANAO comment:** ANAO has undertaken a co-ordinated review of seven major Commonwealth IT outsourcing agreements in order to form a view as to the appropriate accounting treatment of the relevant component parts in each case. Of the seven agreements reviewed, ANAO has formed the view that three involve operating leases, while the remaining four involve embedded finance leases on certain equipment (including the three Agreements considered in this audit). DOFA's views on the classification of the IT&T Agreements as service agreements that do not inherently give rise to embedded finance leases is not in accordance with ANAO's assessment of the economic substance of a number of the transactions (for example, see Figure 7.2 in respect to Group 5). In all cases, materiality considerations were also applied to determine whether the lease component should be accounted for separately in the relevant agencies' financial statements for 1999–2000. Nevertheless, ANAO would encourage the agencies involved in the four Agreements referred to above to have those leases identified as finance leases in next year's financial statements.

7.29 The relevant accounting standard states that the passing of substantially all the risks and benefits incident to ownership from a lessor

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161 Finance and operating leases in the context of tender evaluations are discussed further in Audit Report No. 25 1998-99 *DASFLEET Sale*, pp49-54.

to a lessee is normally presumed where both the following criteria are satisfied: the lease is non-cancellable; and either one or both of the following presumptive tests are met—the lease term is for 75 percent or more of the remaining economic life of the asset; or the present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased asset at the inception of the lease. ANAO's view is that the relevant leases are non-cancellable and the presumptive tests are met; and that substantially all the risks and benefits of ownership have been transferred to the Commonwealth. While ANAO notes the disagreement based on specialist advice received, it considers that the arrangements accord with the intent and provisions of the relevant accounting standard. This is not a discretionary decision.

7.30 **Finding:** Under each Agreement, the Commonwealth has substantially underwritten the capital risk associated with dedicated assets used by the ESP in the delivery of the outsourced services such that the Commonwealth has contracted to keep the respective ESPs whole in respect of their capital investment in those assets. In each case, the agencies have the option to purchase these assets from the ESP at the end of the term at their net book value. ANAO analysed the contractual arrangements in the Cluster 3, ATO and Group 5 Agreements for dedicated equipment leased to agencies by the ESP and concluded that the economic substance of the transactions are that the Commonwealth bears the ownership risk. ANAO considers that the leases reviewed in this audit constitute finance leases rather than operating leases as proposed by OASITO.

Recommendation No. 13

7.31 ANAO *recommends* that, in conducting future IT outsourcing tender evaluations, relevant agencies:

a) identify the risks and benefits relating to ownership of assets that will be borne by each party under the proposed leasing arrangements in order to properly identify the economic substance of the transaction; and

b) inform the decision-maker of the financial implications of the proposed operating or finance equipment lease arrangements prior to execution of the final contract.

7.32 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response:***
  - Part (a): **Agree with qualification**. Based on expert advice from a number of accounting firms, a law firm and a specialist leasing adviser, the Finance and Administration portfolio does not agree

with ANAO's characterisation of certain equipment components of the IT service agreements. The Australian Bureau of Statistics has indicated it will follow this treatment for Government Finance Statistics purposes. OASITO does not accept that the evaluations have failed to "properly identify the economic substance of the transaction".

– Part (b): **Agree with qualification**. The evaluation reports will include an explanation of the accounting treatment and any associated liabilities. However, based on expert advice the Finance and Administration portfolio disagrees with ANAO's characterisation of certain equipment components of the IT service agreements.

7.33 ***ANAO comment:*** Refer to ANAO comment at paragraphs 7.28–7.29.

Implications for evaluation of agency cost savings

7.34 The OASITO Financial Evaluation Guidelines developed for the Cluster 3, ATO and Group 5 tenders, as originally issued, included provision for an adjustment representing the cost to agencies of purchasing, at NBV, the assets dedicated to delivery of the services back from the ESP at the end of the Agreement. This was to enable the agencies to either on-sell to an alternative provider or to bring the services back in-house, and was treated as an increase in the tenderers' price for the purposes of the business case analysis.

7.35 The Cluster 3 evaluation included an adjustment to tenderers' prices for the estimated NBV of tenderers' assets at the end of the contract term. This overstated, for evaluation purposes, the financial cost to the Commonwealth of outsourcing as it did not appropriately recognise the FMV of those assets, which should have been offset against the NBV cost. This adjustment related to an assumption about the scenario that would apply at the end of the contract. It did not represent recognition of the costs associated with the Commonwealth's contractual obligation in respect of tenderers' assets, or of the nature of the leases under which the equipment was provided to agencies.

7.36 In February 1999, OASITO concluded that, based on the clarification of Government policy in the Prime Minister's December 1998 letter, an assumed buy-back of tenderers' assets as part of the financial evaluation was not appropriate and that those amounts would be excluded from the savings analysis in current and future tenders. The reason identified for this position was principally that the Government had made a decision to outsource, as clarified in the Prime Minister's letter, and it was therefore unlikely the Commonwealth would be re-acquiring the assets to bring IT service provision back in-house. The expectation was that the initial contract would be extended in accordance with the extension clauses, or, alternatively, replaced by a new outsourcing contract following a competitive bid process.

7.37 OASITO advised ANAO that the Commonwealth's obligation in regard to ESPs' assets:

> *…is a contingent liability which only becomes payable if the assets in question are repurchased (which implies insourcing) or disposed of (which is difficult to envision if agencies are to continue in operation). OASITO's view, consistent with Government policy, is that outsourcing will continue indefinitely, either by means of a contract extension (in which case the contingent liability will not be crystallised) or by replacement of another vendor (in which case the assets will be transferred to the incoming vendor at book value and no liability will crystallise). Consequently, the most appropriate treatment of this issue is to exclude the contingent liability from the "base" financial evaluation, and to model the different liability scenarios in the form of sensitivity analysis.*

7.38 ANAO does not agree that the most appropriate treatment is the exclusion from the evaluation of Commonwealth financial obligations for tenderers' end-of-term assets. The Commonwealth exposure arises from the probable financial costs of technical obsolescence of IT assets and diminished service potential, which are not borne by the tenderers. The transfer of tenderers' capital risk on assets to the Commonwealth under the finance lease arrangements entered into is reflected in lower lease pricing than would otherwise have been tendered. This is because tenderers are able to identify the residual capital value or lease payments as a Commonwealth termination obligation rather than seeking to recover the full capital cost of equipment in the evaluation period.

7.39 ANAO considers that, in recognition of this Commonwealth contractual obligation, the financial evaluation should include, at a minimum, an estimate of the difference between NBV[162] and FMV of tenderers' dedicated assets at the end of the evaluation period as a cost of outsourcing. This economic cost will generally apply in some form in the scenarios likely to arise at the end of the five year contract term.[163]

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[162] In the case of Group 5, the residual Commonwealth obligation is in respect of the shortfall between the outstanding lease payments on surplus desktop equipment, and the wholesale FMV of the equipment. Therefore, this is the difference that should be captured in the evaluation.

[163] Scenarios in which the cost would not arise are in the event of the FMV of the assets being equal to or greater than the NBV at the end of the period, which is extremely unlikely given the high rate of obsolescence of IT equipment; or where the ESP redeploys the equipment elsewhere in its business, which is unlikely for large volumes of equipment. In all other potential scenarios, the Commonwealth will bear the cost of technical obsolescence and loss of service potential on the ESP's assets on hand at the end of the initial contract term, either in the form of an opportunity cost (as in the business-as-usual case) or as a direct financial cost.

Omitting this adjustment distorts the evaluation as the Commonwealth's financial exposures under the outsourcing option are not fully captured in the financial evaluation report.

7.40 In analysing the effect of this adjustment, ANAO applied the assumption that FMV represents 50 percent of NBV, as in the analysis regarding recognition of end-of-period agency assets. ANAO's analysis indicates that including an estimate of the Commonwealth's contractual obligations in respect to tenderers' end-of-period assets reduces the direct agency financial savings projected at the selection of preferred tenderer for the ATO tender by about one-fifth. In the Cluster 3 tender, the direct agency financial savings would increase by 4 percent over those reported due to the overstatement of the obligation under the methodology applied in that tender.

7.41 In the Group 5 tender, including the Commonwealth's estimated contractual obligation in respect of the successful tenderer's end-of-period assets reduces direct agency savings at the preferred tenderer stage by a further $2.62 million (NPV $1.78 million).[164] This is nearly three times the direct savings reported at this stage of $0.96 million. This impact is reduced at the final contract stage, representing a 110 percent decrease in savings for Group 5 agencies.

7.42 **Finding:** The transfer of tenderers' capital risk on assets to the Commonwealth under the finance leasing arrangements entered into is reflected in lower lease pricing than would otherwise have been tendered. This is because tenderers are able to identify the residual capital value or lease payments as a Commonwealth termination obligation rather than seeking to recover the full capital cost of equipment in the evaluation period. In recognition of this Commonwealth contractual obligation, the financial evaluation should include, at a minimum, an estimate of the difference between NBV (or total lease payments where appropriate) and FMV of tenderers' dedicated assets at the end of the evaluation period as a cost of outsourcing. The Commonwealth exposure arises from the probable financial costs of technical obsolescence of IT assets and diminished service potential, which are not borne by the tenderers. This economic cost will generally apply in some form in the scenarios likely to arise at the end of the five year contract term. Omitting this adjustment distorts the evaluation as the Commonwealth's exposures under the outsourcing option are not fully captured in the financial evaluation report.

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164 Calculated as (NBV-FMV) + Residual Outstanding Lease Payments. Residual Outstanding Lease Payments calculated as Outstanding Lease Payments at end of Year 5-NBV.

7.43 ANAO's analysis indicates that including an estimate of the Commonwealth's contractual obligations in respect to tenderers' end-of-period assets reduces the direct agency financial savings projected in the ATO tender at the selection of preferred tenderer by about one-fifth. In the Cluster 3 tender, the direct agency financial savings would increase by 4 percent over those reported due to the overstatement of the obligation under the methodology applied in that tender. For Group 5, including the Commonwealth's estimated contractual obligation in respect of the successful tenderer's end-of-period assets reduces direct agency savings at the preferred tenderer stage by a further $2.62 million (NPV $1.78 million). This is nearly three times the direct savings reported at this stage of $0.96 million. This impact is reduced at the final contract stage, representing a 110 percent decrease in savings for Group 5 agencies.

Recommendation No. 14

7.44 ANAO *recommends* that, for future IT outsourcing tenders, relevant agencies properly account in the financial evaluation for any residual end-of-period Commonwealth obligations arising from underwriting tenderers' asset risk associated with the outsourced services.

7.45 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response:*** **Disagree.** The base financial evaluation should not include a contingent liability in relation to dedicated end of term assets. Any contingent liabilities will be disclosed in the evaluation reports in the form of scenario sensitivity analysis. This treatment is consistent with expert advice obtained by OASITO and consistent with Government policy on IT outsourcing.

7.46 ***ANAO comment:*** ANAO does not consider that the most appropriate treatment is the exclusion from the base financial evaluation of Commonwealth financial obligations for tenderers' end-of-term assets. The Commonwealth contractually bears the cost of technical obsolescence and the loss of service potential on the external service provider's assets on hand at the end of the initial contract term, either in the form of an opportunity cost or as a direct financial cost. Omitting this adjustment distorts the evaluation as the Commonwealth's financial exposures under the outsourcing option are not fully captured in the financial evaluation report (refer discussion at paragraphs 7.38–7.39).

Implications for financial evaluation outcomes

7.47 The evaluation adjustments identified by ANAO in respect to end-of-period agency and tenderer assets result in significant reductions to the estimated direct agency financial savings from outsourcing projected in the ATO and Group 5 tenders (see Figure 7.3). Of the two adjustments identified, inclusion of the estimated end-of-period FMV of agency assets had the largest impact on the cost savings projected under the evaluation methodology applied in the Cluster 3, ATO and Group 5 tenders. At the preferred tenderer stage, this adjustment accounted for 59 percent of the aggregated reduction in agency cost savings for ATO, and 68 percent for Group 5.

Figure 7.3

Estimated adjustments to agency financial savings for end-of-period assets

	Cluster 3 Savings		**ATO[2] Savings**		**Group 5 Savings**	
	Nominal ***$m***	NPV[1] ***$m***	Nominal ***$m***	NPV[1] ***$m***	Nominal ***$m***	NPV[1] ***$m***
Tender Evaluation Financial Savings at Selection of Preferred Tenderer (A)	***62.03***	***49.94***	***60.44***[3]	***47.10***[3]	***0.96***	***0.17***
ANAO estimated end-of-period asset adjustments:						
• Estimated FMV of agency end-of-period assets[4]	(3.83)	(2.67)	(18.76)	(12.77)	(5.49)	(3.74)
• Estimated cost of net Commonwealth obligation for end-of-period ESP assets[5]	2.60	1.79	(12.85)	(8.75)	(2.62)[6]	(1.78)[6]
Revised estimated financial savings at selection of preferred tenderer (B)	**60.80**	**49.06**	**28.83**	**25.58**	**(7.15)**	**(5.35)**
Variance due to end-of-period asset adjustments (C = (A-B))	(1.23)	(0.88)	(31.61)	(21.52)	(8.11)	(5.52)
Revised savings as % of agency baseline costs	27.8%	27.6%	5.1%	5.6%	(7.3%)	(6.8%)
Tender Evaluation Financial Savings Adjusted for Final Contract Pricing	***63.15***	***50.91***	***62.45***[3]	***48.76***[3]	***2.40***	***1.33***
Less: Variance due to end-of-period asset adjustments (see C above)	(1.23)	(0.88)	(31.61)	(21.52)	(8.11)	(5.52)
Revised estimated financial savings at final contract	**61.92**	**50.03**	**30.84**	**27.24**	**(5.71)**	**(4.19)**

Note 1: NPV calculated at a discount rate of 8 percent.

Note 2: Direct financial savings to the ATO reported in the tender evaluation of $60.44m (NPV $47.1m) excluded the effect of telecommunications costs of $20.97m (NPV $16.82m) arising under the final contract with the successful tenderer. These were additional costs incurred by virtue of the ATO electing to have the ESP fully manage the delivery of telecommunications services, an additional service not envisaged in the original compliant tender bid.

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Note 3: Direct financial savings to the ATO identified in the tender evaluation were overstated by $3.91m ($3.6m at final contract stage) due to the incorrect exclusion of sales tax included in the pricing offered for contractual purposes by the successful tenderer. Although neutral from a Commonwealth perspective after the application of competitive neutrality, those costs reduce the direct financial savings realisable by the ATO from those reported in the financial evaluation.

Note 4: FMV of agency assets calculated at 50 percent of NBV. A FMV at a higher percentage of NBV would reduce the size of the savings attributable to outsourcing, while a FMV at lower percentage of NBV would increase savings.

Note 5: FMV of vendor assets calculated at 50 percent of NBV. FMV at a higher percentage of NBV increases the size of the savings attributable to outsourcing, while a FMV at a lower percentage of NBV would decrease the savings from outsourcing.

Note 6: Calculated as (NBV-FMV) + Residual Outstanding Lease Payments. Residual Outstanding Lease Payments calculated as Outstanding Lease Payments at end of Year 5-NBV. This reflects the estimated disengagement payment identified by the ESP.

Source: ANAO analysis of Cluster 3, ATO and Group 5 savings models and cost models.

7.48 At the preferred tenderer stage, the aggregate end-of-period asset adjustments identified by ANAO[165] reduce the direct cost savings to the ATO as quantified in the tender evaluation by an estimated $31.61 million to $28.83 million (NPV $25.58 million), a saving of 5.1 percent of projected agency business-as-usual expenditure. At the same stage in the Group 5 tender, the aggregate adjustments reduce reported direct agency savings by an estimated $8.11 million, resulting in a 7.3 percent cost premium of $7.15 million (negative NPV $5.35 million) to the Group agencies from outsourcing. At the final contract stage, adjusted direct savings for the ATO were estimated to be $30.84 million or 5.4 percent (NPV $27.24 million). At the same stage, the aggregate adjustments result in an estimated 5.8 percent net cost of $5.71 million (negative NPV $4.19 million) to the Group 5 agencies from outsourcing rather than financial savings.

7.49 The Cluster 3 tender evaluation identified significant direct financial savings to the agencies from outsourcing, amounting to some $50 million or 28 percent of agency baseline costs. This level of savings was not materially changed by the application of the end-of-period asset adjustments outlined in Figure 7.3. As noted, the notional buy-back of tenderers' assets in the Cluster 3 financial evaluation related to an assumption about the scenario that would apply at the end of the contract, and did not represent recognition of the Commonwealth's contractual obligation in respect of tenderers' assets, or of the future service potential of agencies' assets. However, the practical effect was that it provided a 'de-facto' mechanism for improving the comparability between the

165 Comprising an adjustment to take into account the residual value of end-of-period agency assets and an adjustment to take into account residual end-of-period Commonwealth obligations in respect of vendor assets.

purchase of assets in the agency cost baseline and the leasing of assets from the ESPs. Consequently, the end-of-period asset adjustments identified in this chapter had a minimal overall effect on the direct agency cost savings projected in the Cluster 3 tender evaluation.

Change to financial evaluation methodology

7.50 Following discussions with agency evaluation representatives in the weeks preceding finalisation of the ATO and Group 5 tender evaluations, OASITO revised the previously advised financial evaluation methodology for those tenders to exclude the adjustment for end-of-term purchase of tenderers' assets. OASITO formally advised the Group 5 Steering Committee three days prior to endorsement of the preferred tenderer that, after consultation with an accounting firm, it had concluded that the notional asset purchase at the end of the term was an incorrect application of the cash analysis view. OASITO advised the ATO Evaluation Committee in similar terms. The evaluation teams were advised that OASITO required that the cost of re-purchasing tenderers' assets be excluded from the financial evaluation.

7.51 The exclusion of end-of-period assets was raised as an issue with OASITO by both ATO and Group 5 agency representatives, with the agency concerns focusing on the ability to validly compare agency capital acquisition cash flows with the equipment lease costs in tenderers' cash flows under the revised methodology.[166] For example, the ATO Financial Evaluation Report noted that '*ATO considers that these costs were included to provide a normalised costing analysis compared with the business-as-usual ATO cost baseline. In the baseline costing model the ATO would still retain ownership of the assets following the end of the evaluation costing period (5 years)*'. Agencies' arguments were not accepted by OASITO on the basis that it viewed the end-of-period asset adjustment as only relating to an assumption about the scenario that would apply at the end of the contract term (which OASITO viewed as implying re-insourcing[167]), which OASITO did not consider to be an appropriate assumption in view of Government policy regarding IT outsourcing (see paragraph 7.35).

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166 A member of the Group 5 Financial Evaluation Team advised OASITO that: *the asset buy back price needed to be kept in the model if the model, as currently structured, is to validly compare tenders with business as usual for the Group. Removal of the asset buy back price from the model would have a significant effect in making outsourcing seem much less costly than it would really be.*

167 The OASITO Financial Evaluation Guidelines as originally issued for the Cluster 3, ATO and Group 5 tenders identified that the provision for an adjustment representing the cost to agencies of purchasing, at net book value, the assets dedicated to delivery of the services back from the ESP at the end of the agreement also related to enabling the agencies to on-sell to an alternative provider.

7.52 The Group 5 Evaluation Committee requested, but did not receive, a copy of the accounting advice referred to by OASITO.[168] In October 1999, OASITO advised ANAO that there was no documentation of its consultation with any advisers with respect to this matter. OASITO further advised in March 2000 that the accounting advice had been verbal, and that it was not considered necessary to obtain written advice at that point.

7.53 ANAO considers that, given the potentially significant implications of the exclusion of end-of-period asset values from the financial evaluation methodology originally advised to agencies, good administrative practice would have been for OASITO to have obtained written specialist advice. Providing that advice in a timely manner to the respective Evaluation Committees responsible for advising the Minister would have enabled them to form a considered view on the appropriateness of the change in methodology. Given the potential for such changes in methodology between and during tenders to affect the savings identified, ANAO also considers that, in future IT outsourcing tender evaluations, the reasons for, and effects of, alterations in the financial evaluation methodology applied should be documented and made transparent to the decision-maker.

7.54 ANAO considers that the financial evaluation methodology employed in the ATO and Group 5 tenders could have been materially improved. The ATO and Group 5 RFTs stipulated that the Commonwealth would not enter into an outsourcing agreement unless it was satisfied that the preferred tenderer offered substantial and acceptable cost savings. The evaluation methodology applied did not provide the relevant Ministers with analysis that comprehensively identified the Commonwealth's financial position in respect of each of the options under consideration. The materiality of the estimated adjustments[169] in respect of end-of-period assets suggests that it would be prudent in future IT outsourcing tenders for the relevant Ministers to be fully informed of the assumptions applied and the sensitivity of the financial outcomes projected to those assumptions.

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168 In March 2000, DoTRS advised ANAO that it made a number of approaches to OASITO in an effort to obtain a copy of the accounting firm's advice, but that OASITO did not produce the documentation sought.

169 Based on an assumption of the FMV of end-of-period assets being 50 percent of their NBV.

7.55 After completion of the ATO and Group 5 tender evaluations, OASITO obtained written advice in July 1999 from the accounting firm that provided the previous verbal advice regarding the financial evaluation methodology to be applied in subsequent tenders. Since that time, OASITO has continued to develop its financial evaluation methodology.

7.56 In April 2000, OASITO advised ANAO that:

> *Difficulties surrounding end of term issues have been acknowledged by OASITO for some time. Last year, OASITO instructed* [an accounting firm] *to develop a methodology that would eliminate the need for assumptions about the sourcing decision for future periods. Our hope was that such a methodology would allow us to avoid the lengthy debates that surrounded this issue in the Group 5 and ATO processes. To that end,* [the accounting firm] *recommended the "position of equivalence" methodology. You raised concerns with that approach and so, following discussions with ANAO,* [the accounting firm] *has developed a further approach which addresses specific future sourcing scenarios. That approach is consistent with the position of equivalence approach, but breaks the analysis down into specific scenarios, each of which can be modelled and presented separately. OASITO believes that either approach would provide a sound basis for the financial evaluation. However, in order to give the decision maker maximum transparency, for future evaluations we intend to adopt the "scenario sensitivity analysis" approach.*

7.57 ANAO understands that a revised financial evaluation methodology was applied by OASITO in the Health Group tender completed in December 1999, and ANAO will consider the revised methodology in the context of the forthcoming performance audit of the Health Group tender scheduled for commencement in 2000-01. ANAO continues to have major concerns regarding the treatment of agency end-of-term assets and the Commonwealth's obligations applying to equipment provided by ESPs in the financial evaluation methodologies adopted by OASITO, and the capacity of those methodologies to provide a complete and reliable analysis of the value accruing to the Commonwealth from IT outsourcing.

7.58 **Finding:** Following discussions with agency evaluation representatives in the weeks preceding finalisation of the ATO and Group 5 tender evaluations, OASITO revised the previously advised financial evaluation methodology for those tenders to exclude the adjustment for end-of-term purchase of tenderers' assets. In March 2000, OASITO advised ANAO that the accounting advice obtained by it regarding this issue had been verbal, and that it was not considered necessary to obtain written advice at that point. ANAO considers that, given the potentially significant implications of the exclusion of end-of-period asset values from the financial evaluation methodology originally advised to the ATO and Group 5 agencies, good administrative practice would have been for OASITO to have obtained written specialist advice as a basis for assurance and accountability.

7.59 ANAO considers that the financial evaluation methodology employed in the ATO and Group 5 tenders could have been materially improved. The evaluation methodology applied did not provide the relevant Ministers with analysis that comprehensively identified the Commonwealth's financial position in respect of each of the options under consideration.

7.60 The evaluation adjustments identified by ANAO in respect to end-of-period assets result in potentially significant reductions in projected savings from outsourcing for the ATO and Group 5 tenders. At the preferred tenderer stage, the aggregate end-of-period asset adjustments identified by ANAO reduce direct cost savings to the ATO as quantified in the tender evaluation by an estimated $31.61 million to $28.83 million (NPV $25.58 million). The adjusted estimate represents a saving of 5.1 percent of projected agency business-as-usual expenditure. At the same stage in the Group 5 tender, the aggregate adjustments reduce reported direct agency savings by an estimated $8.11 million, resulting in a 7.3 percent net cost of $7.15 million (negative NPV $5.35 million) to the Group agencies. At the final contract stage, adjusted direct savings for the ATO were estimated to be $30.84 million or 5.4 percent (NPV $27.24 million). At the same stage, the aggregate adjustments result in an estimated 5.8 percent net cost of $5.71 million (negative NPV $4.19 million) to the Group 5 agencies from outsourcing rather than financial savings.

Competitive neutrality adjustments

7.61 The *Commonwealth Competitive Neutrality Policy Statement, June 1996* (the Policy) states that the intention of implementing CN policy arrangements is to remove resource allocation distortions arising out of public ownership of significant business activities and to improve competitive processes. CN requires that, where governments choose to provide services through market-based mechanisms that allow actual or potential competition from a private sector provider, that competition should be fair.

7.62 The Policy states that CN requirements will be applied to significant government business activities. It also states that, in regard to competitive tendering processes within public sector agencies where in-house providers supply a service under contract, there is a need to ensure that appropriate CN arrangements and management practices are in place.[170] This requires that in-house tenders be prepared in isolation from those in the organisation responsible for evaluating tenders and awarding contracts; and reflect full cost attribution, including taxation, return on capital and all relevant overheads.[171] Under the IT Initiative, it is open to agencies to consider the costs and benefits of in-house bids on a case by case basis. Where in-house bids are permitted, agencies are required to ensure they conform with CN requirements. In-house bids were not permitted in any of the tenders reviewed by ANAO.

7.63 The August 2000 DOFA whole-of-government response to the proposed audit report commented that:

> *The presentation of total savings figures for the contracts inclusive of competitive neutrality is appropriate, as it is consistent with stated Government policy…Treasury has confirmed that it supports the inclusion of competitive neutrality in the financial evaluations, regardless of whether a formal in-house bid has been declared.*

7.64 After the direct financial savings to agencies from outsourcing to each tenderer had been calculated, notional CN adjustments were added to the agency cost baselines for costs faced by tenderers that agencies were not subject to. Typically, these include a requirement to earn a commercial rate of return on capital and the payment of wholesale sales tax and payroll tax. Those notional adjustments were then added to the financial savings offered by each tenderer over the agency business-as-usual costs, with the total reported as post-CN savings.

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170 *Commonwealth Competitive Neutrality Policy Statement*, June 1996, Attachment B, p.41.

171 The *Commonwealth Competitive Neutrality Guidelines for Managers*, *1998*, p2 state that the criteria applying to the determination of government activities that will be subject to CN arrangements operate to exclude Government functions which are budget funded service delivery activities where there is no distinction between the purchaser and provider of the service. The Guidelines state that where there is separation between the purchaser and provider, such as in the case of competitive tendering with an in-house bid, the provider activity may be regarded as subject to CN if it is a business activity and falls above the 'significance' threshold.

Methodology

7.65 The largest component of the CN adjustments made in each tender related to the calculation of a required rate of return for agencies (representing about 91 percent of the total Cluster 3 CN adjustment, and about 75 percent for ATO and Group 5). The rate of return adjustment made in respect of Cluster 3 agencies was $30.08 million, compared to $29.16 million for ATO and $5.35 million for Group 5 (see Figure 7.4).

7.66 The relative size of the CN adjustments for Cluster 3 and the ATO was outside the expected outcome given the significant difference in the size of the transactions and in the capital applied in delivery of the services. Commercial practice is to apply the rate of return to the relevant asset base. However, in calculating the CN adjustment for rate of return in the Cluster 3 tender, a nominal rate of return using a weighted average cost of capital (WACC) of 12.89 percent was applied to the total projected agency costs in delivering the tendered services, rather than to the agency investment in assets.

7.67 This methodology was based on advice provided to OASITO by DOFA in December 1997. DOFA advised OASITO that the WACC should be applied to the total costs of agencies in delivering the relevant IT infrastructure services rather than on capital expenditure as the former was '*a fairer representation of government investment in those services*'. The application of the rate of return adjustment to total costs significantly overstated the Cluster 3 CN adjustment and, consequently, the post-CN savings attributed to the Cluster 3 tender.

7.68 In July 1998, OASITO revised the methodology to be applied in determining the CN rate of return adjustment in subsequent tenders, with the WACC to be applied to the relevant asset base rather than agencies' total costs in delivering the IT services. In the ATO tender, the CN rate of return adjustment was calculated on the basis of a nominal rate of return on agency hardware and software assets using a WACC of 12.87 percent.[172] In the Group 5 tender, the adjustment was calculated on the basis of a real return of 10.89 percent on agency assets.[173]

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172 This rate was obtained from a paper developed in March 1997 by an external consultant engaged by OGIT to conduct a calculation of the WACC for the IT outsourcing industry that OGIT could apply when developing baseline costs and capital budgeting financial models. The paper was based on analysis of listed companies in Australia, the United States and the United Kingdom that provide outsourcing and IT services. The WACC of 12.87 percent used in the ATO tender was identified as the midpoint of the range stated by the consultant as relevant to Australia of between 12.79 percent and 12.95 percent.

173 The Group 5 Final IT Services Evaluation Report noted that this rate had been identified utilising work done for OASITO by an external consultant on commercial rates of return for IT outsourcing companies.

7.69 The methodology applied in each tender reviewed to calculate the CN rate of return adjustments reflected an assumption that the ESP bears substantially all the risks and benefits of ownership of the assets employed in delivering the tendered services and that, therefore, its tendered price included an allowance for a return on capital to compensate it for the risks of ownership. Where that is the case, it would be appropriate for the CN adjustment applied to agency assets to include an opportunity cost of capital in order to provide a comparison between agency and tenderers' costs as if each were required to operate on the same basis. On the basis of that assumption, the WACC rates applied in the Cluster 3, ATO and Group 5 tenders incorporated an allowance for equity capital return.

7.70 However, as noted above, under the finance leasing arrangements set out in the Cluster 3, ATO and Group 5 Agreements, the Commonwealth has underwritten the capital risk of tenderers in respect of dedicated assets used in the delivery of the tendered services such that, in normal circumstances, they are not exposed to financial losses on relevant assets. In view of that obligation, and the commensurately reduced lease pricing offered by tenderers as a result of the lower risk profile resulting from it, ANAO considers that the CN rate of return adjustment applied to the agency cost baseline should have reflected a lower rate of return requirement. This would have provided a more soundly-based comparison with the conditions on which the tenderers' pricing was based.

7.71 Guidance on rate of return issues released by the Commonwealth Competitive Neutrality Complaints Office[174] in December 1998 indicated that typical rate of return targets for low risk businesses would equate to the long term bond rate plus a 3 percent risk premium. The margin for medium (average) risk businesses would be 5 percent, and 7 percent for high risk businesses.[175]

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[174] The Commonwealth Competitive Neutrality Complaints Office is an autonomous unit within the Productivity Commission. It was established under the *Productivity Commission Act 1998* to receive complaints, undertake complaints investigations and advise the Treasurer on the application of competitive neutrality to Commonwealth Government activities.

[175] Commonwealth Competitive Neutrality Complaints Office (CCNCO) 1998, *Rate of Return Issues*, CCNCO Research Paper, Productivity Commission, Canberra, December, p vii.

7.72 Given the low business risk for the ESPs associated with assets under the outsourcing Agreements, ANAO has calculated an indicative rate of return adjustment in respect of agency assets for each tender based on the five year Commonwealth bond rate applying at the time of selection of preferred tenderer (the financing cost for Commonwealth assets), plus a three percent risk premium.[176] The lowering of the risk premium for capital in the CN adjustment significantly reduces the notional rate of return required on agency assets.[177] Applying the Commonwealth bond rate plus a 3 percent risk premium to agencies' asset base reduces the aggregate CN adjustment reported in the Cluster 3, ATO and Group 5 tenders by $35.93 million (NPV $28.87 million) (see Figure 7.4).

7.73 The estimated CN rate of return adjustment for Cluster 3, based on a three percent risk premium, is $24.47 million or 81 percent lower than that reported in the tender evaluation (NPV $19.77 million). The largest part of this reduction, $22.39 million, results from applying the rate of return to the agency asset base rather than total agency costs. The remainder is due to the application of a reduced rate of return to the agency assets that equate with tenderers' dedicated assets (8.6 percent compared to 12.89 percent in the tender evaluation).

7.74 Using the same approach, the indicative CN rate of return adjustment calculated by ANAO for the ATO tender is $9.99 million lower than the adjustment reported in the tender evaluation (NPV $7.95 million), a reduction of 34 percent. For Group 5, the indicative CN rate of return adjustment on assets is $1.47 million or about 28 percent lower than that reported in the tender evaluation (NPV $1.15 million).

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176 ANAO received specialist advice to confirm the reasonableness of this assumption.

177 A real rate of return is appropriate if real cash flows are involved. Alternatively, if nominal cash flows are involved, a nominal rate of return should be applied. To provide comparability with the methodology used by OASITO, a nominal return has been used for those tenders in which OASITO applied a nominal rate, being Cluster 3 and ATO. Because a real return was used in calculating the CN adjustment in the Group 5 tender, ANAO has also applied a real rate of return for that tender.

Figure 7.4

Comparison of reported and ANAO competitive neutrality adjustments

Reported CN adjustments:	*Cluster 3* Nominal 12.89% $m	*ATO* Nominal 12.87% $m	*Group 5* Real 10.89% $m
Rate of return adjustment	30.08[1]	29.16[2]	5.35[2]
Net other adjustments[5]	3.13	5.46	1.98
Reported CN adjustment	***33.21***	***34.62***	***7.33***
NPV	27.14	27.64	5.85
ANAO indicative CN adjustments:	Nominal 8.6%[3] $m	Nominal 8.16%[3] $m	Real 6.16%[3] $m
Rate of return adjustment[4]	5.61	19.17	3.88
Net other adjustments[5]	3.13	5.46	1.98
ANAO estimated CN adjustment	***8.74***	***24.63***	***5.86***
NPV	7.37	19.69	4.70
Estimated variance	***(24.47)***	***(9.99)***	***(1.47)***
Estimated NPV variance	(19.77)	(7.95)	(1.15)

Note 1: Rate of return adjustment for Cluster 3 was calculated by OASITO as 12.89 percent of total agency cost baseline.

Note 2: Rate of return adjustment for ATO and Group 5 was calculated by OASITO based on a WACC on agency assets.

Note 3: The revised rate of return estimated by ANAO has been applied to agency assets that equate to the classes of tenderers' assets that are dedicated to the delivery of the services to the relevant agencies under each Agreement, and therefore, subject to the Commonwealth's underwriting of tenderers' capital risk. The WACC used in each tender evaluation has been applied to the remaining assets. In the case of the ATO, as all IT infrastructure used to deliver services to the ATO is required to be dedicated, the revised rate of return has been applied to all agency assets. In the case of Cluster 3, the WACC applied in the tender evaluation has been applied to mainframe assets. For Group 5, the WACC applied in the tender evaluation has been applied to assets other than desktop and voice network assets.

Note 4: The revised rates of return for Cluster 3 and ATO are derived from the five year nominal Commonwealth bond rate applicable at the time of selection of preferred tenderer (5.6 percent for Cluster 3, 5.16 percent for ATO), with a 3 percent risk premium then added as an estimate of the ESPs' target rate of return for the relevant assets. In the case of Group 5, a real rate has been applied because a real return was used in the tender evaluation. The expected rate of inflation of 2 percent was deducted from the nominal bond rate of 5.16 percent applicable at selection of preferred tenderer, and the 3 percent risk premium than added to the real bond rate of 3.16 percent. In each case, the indicative rates of return were applied to the average NBV of agency assets in each year based on agency cost models; that is, opening NBV plus closing NBV, divided by two. This is representative of the capital investment by the agency in each year.

Note 5: Includes, where applicable, adjustments for sales tax, payroll tax, stamp duty, insurance and financial institutions duty. Given their relative immateriality, ANAO has applied these adjustments as calculated by OASITO. The discussion at Note 3 Figure 7.3 is neutral after the application of CN adjustments.

Source: Cluster 3, ATO and Group 5 evaluation reports and cost models, and ANAO analysis.

7.75 Finding: The largest component of the CN adjustments made in each tender related to the calculation of a required rate of return for agencies (representing about 91 percent of the total Cluster 3 CN adjustment, about 75 percent for ATO and Group 5). ANAO identified marked deficiencies in the methodology applied to calculate the CN adjustment for rate of return in each tender reviewed, with the methodology applied in the calculation of the adjustment varying between the tenders. Commercial practice is to apply the rate of return on the relevant asset base. However, in calculating the rate of return adjustment in the Cluster 3 tender, a weighted average cost of capital (WACC) of 12.89 percent was applied to all agency outlays. The application of this adjustment to total costs significantly overstated the adjustment and, consequently, the post-CN savings attributable to Cluster 3. In July 1998, OASITO revised the methodology to be applied in determining the CN rate of return adjustment in subsequent tenders, with the WACC to be applied to the relevant capital asset base rather than the agencies' total costs in delivering the IT services.

7.76 Under the finance leasing arrangements set out in the Cluster 3, ATO and Group 5 Agreements, the Commonwealth has underwritten the capital risk of the outsourced providers in respect of dedicated assets, such that they are not exposed to financial losses on those assets. In view of that obligation, and the commensurately reduced lease pricing offered by tenderers as a result of the lower risk profile resulting from it, ANAO considers that the CN rate of return adjustment applied to the agency cost baseline should have reflected a lower rate of return requirement. This would have provided a more soundly-based comparison with the conditions on which the tenderers' pricing was based.

7.77 Guidance on rate of return issues released by the Commonwealth Competitive Neutrality Complaints Office in December 1998 indicated that typical rate of return targets for low risk businesses would equate to the long term bond rate plus a 3 percent risk premium. The lowering of the risk premium for capital in the CN adjustment significantly reduces the notional rate of return required on agency assets. Applying the Commonwealth bond rate plus a 3 percent risk premium to agencies' asset base reduces the aggregate CN adjustment reported in the Cluster 3, ATO and Group 5 tenders by $35.93 million (NPV $28.87 million). The indicative CN adjustments calculated by ANAO are lower than those reported in the Cluster 3 tender evaluation by $24.47 million or 81 percent (NPV $19.77 million); $9.99 million or 34 percent (NPV $7.95 million) lower for the ATO; and $1.47 million or about 28 percent (NPV $1.15 million) lower for Group 5.

Recommendation No. 15

7.78 ANAO *recommends* that, to ensure competitive neutrality adjustments are consistent with the conditions on which tenderers' pricing is based, OASITO, in consultation with DOFA, review the methodology to be applied in future IT outsourcing tenders for the calculation of adjustments for the required rate of return on agency assets in situations where the Commonwealth underwrites the asset risk of tenderers.

7.79 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response:*** **Disagree.** OASITO has previously reviewed the methodology having regard to asset risk allocation issues and has obtained expert advice that no change to the ROI *[return on investment]* component of the competitive neutrality calculation is required. This approach is consistent with Government policy on IT outsourcing.

7.80 ***ANAO comment:*** In ANAO's view, the competitive neutrality adjustment made for operating leases should not be the same as that made for finance leases given that the risks that the Commonwealth bears are materially different in each case. In the case of the leases covered in this audit, ANAO considers that they are finance leases under which the Commonwealth has underwritten the capital risk of tenderers in respect of dedicated assets used in the delivery of the tendered services such that, in normal circumstances, they are not exposed to financial losses on relevant assets (see discussion at paragraphs 7.27–7.29). In view of that obligation, and the commensurately reduced lease pricing offered by tenderers as a result of the lower risk profile resulting from it, ANAO considers that the competitive neutrality rate of return adjustment applied to the agency cost baseline should have reflected a lower notional rate of return requirement. In the case of true operating leases, ANAO would support a higher notional rate of return being required on agency assets as the external service provider has a higher asset risk.

8. Agency Outcomes

This chapter discusses the initial implementation of the Cluster 3, ATO and Group 5 IT&T outsourcing Agreements.

Overview

8.1 The outsourcing agreements considered in this audit had been in operation for relatively short periods. Particularly in the case of the ATO and Group 5 Agreements, it was too early at the time of audit to form clear conclusions regarding the service delivery outcomes obtained by agencies through the outsourcing Agreement. OASITO advised ANAO that, in its view, the benefits and improvements that are implicit in the outsourcing Agreements executed to date under the IT Initiative and/or have been delivered to agencies include:

- the ability of agency management to concentrate on business performance and strategic needs;
- a contractual framework that establishes a very high degree of visibility into IT operating costs and service quality;
- improved responsiveness to agency requirements for substantial changes to IT infrastructure; and
- guaranteed IT costs on a unit-rate basis.

8.2 The extent to which the expected benefits identified by OASITO were realised by agencies in the initial implementation phases of the Cluster 3, ATO and Group 5 Agreements has been variable. However, the outsourcing of IT infrastructure services represents a significant change event that can be expected to result in a period of disruption and instability compared to normal service delivery.[178] The longer-term effectiveness of the Agreements will be determined over their five year terms.

[178] A draft Contract Management Guide released by OASITO in January 2000, stated that *virtually all outsourcing relationships experience difficulty during the first twelve to eighteen months after transfer of operational responsibility.* This 'stabilisation period' encompasses the post-handover migration of infrastructure, introduction of new technologies and generally stabilising the IT environment after handover.

8.3 The Agreement executed under the IT Initiative that has been in operation longest is Cluster 3, which commenced in July 1998. In June 2000, the Cluster advised ANAO that, in the first two years of operation, considerable progress had been achieved across a number of areas of importance to the Cluster. This included the replacement of almost all existing infrastructure with current industry standard systems, and the provision of additional computing capacity and facilities enabling successful delivery of major agency initiatives.

8.4 An issue which has been highlighted by the experience gained to date is the significant additional complexity involved for both parties in managing the delivery of services to a group of agencies.[179] The multi-agency groups, Cluster 3 and Group 5, have experienced, to varying degrees, considerably more disruption to service delivery than has the single agency group, ATO, with significant shortfalls in the provision of contracted service levels during the first year of the Agreements. The ATO ESP advised ANAO in August 2000 that: '*It* [has] *been our general experience that working with single agency groups has been more effective and presented less difficulties at all stages of the procurement.*'

8.5 The experience of Cluster 3 and Group 5 highlighted that both agencies and tenderers underestimated the complexity involved in simultaneously transitioning to an outsourced provider the delivery of IT infrastructure services to a number of agencies. Key areas on which agencies engaged in IT outsourcing arrangements should place particular focus in order to enhance the effectiveness of the initial implementation, as outlined in this chapter, include:

- the preparation for and management of, including expectations from, the initial transition to an outsourced arrangement, particularly where a number of agencies are grouped under a single outsourcing Agreement; and
- the ESP's ability to provide the performance information, including substantiation material, required by agencies to support effective contract management.

Agency service delivery outcomes

8.6 The Cluster 3, ATO and Group 5 Agreements outline a comprehensive series of services to be provided by the relevant ESP, and specify the levels to which those services are to be provided. The required

[179] In June 1999, IP Australia reported that clustering in an IT outsourcing initiative had proved to be more complex and difficult for both the ESP and Cluster members than had been imagined.

services and service levels specified in an outsourcing agreement are an important part of the monitoring and management of an ESP's performance by the customer. They provide a visible indicator of performance, and also play an important role in determining the aspects of service delivery that will be the focus of management by both parties. Hence, it is critical that service levels are defined to effectively cover the aspects of service delivery most important to the customer's business requirements.

8.7 However, an attendant risk with any service agreement is that the ESP will not deliver the contracted services to the agreed level, quality and cost outcomes. Accordingly, each Agreement also provides agencies with a number of potential remedies in the event of unsatisfactory performance by the ESP. These include the ability to sue for damages, contract termination and removal of services. However, the most practical contractual remedy on a day-to-day basis for the non-delivery of contracted services is service credits, which can be used to complement general relationship management techniques.[180] Each Agreement required that contracted service levels be delivered as from handover, and for service credits to potentially apply where this was not achieved.

8.8 Service credits, which are typically paid to the agencies in the form of credits deducted off future invoices, are calculated in accordance with formulae negotiated in the context of each Agreement. Those formulae identify the quantum of service credit arising for a failure to achieve a nominated level of service. There are aspects of service delivery under the Cluster 3, ATO and Group 5 Agreements that are not reflected in the service level/service credit regime. However, the level of service credits that have arisen under each Agreement provides an indication of the extent to which the contracted services have been successfully delivered.

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180 The ATO and Group 5 Agreements also sought to manage the risks associated with initial transition of the services to the ESP through the inclusion of acceptance tests and transition milestones, on which payment of up-front transition payments was contingent. Both Agreements also provided that the relevant agencies were not liable to pay service charges until the ESP had successfully passed acceptance tests identified by the agencies. However, Group 5 elected not to identify or apply acceptance tests, with reliance placed on the service credit arrangements that would apply in the event the ESP failed to deliver to the contracted service levels as from handover. The Group 5 Agreement also specified a series of milestones and deliverables upon which payment for transition services was contingent. Although the ESP had not completed all identified milestones and deliverables prior to handover, the Group 5 Management Committee elected to make full payment of the transition payment on the basis that if the ESP did not deliver fully to contracted service levels as from handover it would be subject to service credits. As at December 1999, the transition milestones and deliverables identified in the Agreement as the minimum requirements to satisfy the acceptance criteria upon which the transition payment was contingent had not been fully completed.

ATO

8.9 Of the three Agreements reviewed, the transfer of responsibility for the outsourced services to the ESP appears to have proceeded with the fewest initial problems in the case of the single agency ATO Agreement. In that case, operational services were generally delivered to expected levels as from their handover in late June 1999. This is indicated by the relatively minor level of service credits incurred by the ESP during the first year of the Agreement, although the areas in which service delivery disruption did occur were areas of high end-user impact.[181] Service credits of $1.1 million imposed by the ATO to June 2000 represented about 1.5 percent of service charges paid, although those amounts remain interim until the ESP is able to provide the ATO with the information necessary to fully substantiate reported performance.

8.10 Many of the changes to existing IT infrastructure needed to transition the ATO to the ESP's tendered solution were not planned to occur until some months after handover to minimise potential disruption to the ATO's implementation of tax reform. However, there was also a very significant demand for major project work in the first year of the Agreement, primarily associated with the tax reform program. This has created some difficulties in developing and bedding down agreed procedures to support this type of work in a manner that satisfies end user requirements and timeframes. Over 1200 individual work requests were submitted to the ESP in the first year, generating some backlog. ATO advised ANAO that there has been improvement in this area as procedures have matured.

Group 5

8.11 Group 5 adopted a similar approach to the ATO in that, with the exception of help desk services, the existing infrastructure was kept 'as is' after handover to mitigate the risk of disruption to services. Despite this, Group 5 experienced service delivery instability following handover to the ESP on 1 July 1999, with the severity and length of those problems varying between Group agencies. Contributing factors were the

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181 These areas principally included help desk services and moves, adds and changes to the existing infrastructure. Help desk services were the main area of initial change in existing ATO infrastructure upon handover, with the ESP establishing, through a subcontractor, a new help desk and problem management facility in Canberra. The existing ATO help desk facility had been located in Sydney. There was initial disruption to help desk services in the first months after handover, related in part to a loss of corporate knowledge in help desk staff after the ESP obtained only negligible take up of jobs by the existing ATO staff. ATO advised that this, coupled with the industry development requirement to locate the help desk in Canberra, removed the opportunity for a prolonged handover to the Canberra site.

effectiveness of the knowledge-transfer processes undertaken to support the ESP's initial understanding of the Group's requirements, business and IT environments; the low numbers of agency staff transferring to the ESP; and the complexity of transitioning multiple agencies simultaneously. In commenting on the proposed audit report, the Group 5 ESP advised ANAO that one of the main contributors to the effectiveness of the knowledge transfer processes was the varying quality and currency of agency documentation.

8.12 In August 1999, the Group 5 Management Committee advised the ESP that the service difficulties represented a significant erosion over the services delivered in agencies prior to handover. Although acknowledging that the ESP was attempting to fix the problems, the Group wished to put on record that the service problems were having a real and significant impact on business in Group 5 agencies, and seriously affecting productivity.

8.13 Particular problems were experienced in regard to the operation of the Banyan Vines network operating system used in two of the five agencies. Significant disruptions in the availability of this system were experienced during the first six months of operation, with agency personnel experiencing substantial data loss and reduced efficiency.[182] Following intensive investigation by the ESP, the Banyan Vines system, which is to be replaced in 2000, was stabilised after root cause analysis identified an embedded fault in the existing agency equipment.

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182 In September 1999, the DoTRS contract manager reported that since the July handover, the Department had experienced 16 days worth of outages and a total of 32 days worth of lost data, with an estimated net financial impact in terms of productivity in the order of $3 million. By November 1999, DoTRS reported that stability seemed to have been restored to a degree. The Department continued to experience server outages, but the interruptions were not as major as those in the past. In commenting on the proposed audit report, the Group 5 ESP advised ANAO that: *'The estimate that there was sixteen days worth of outages and 32 days worth of data lost, should be qualified. DoTRS had approximately 30 Banyan Vines file servers. Each one services between 3 and 150 users. Approximately a quarter of those servers were impacted by this embedded fault. The servers were not all down at the same time. The server time lost for a number of different servers occurred over a period of 16 days, but not all Departmental users were impacted for that time. Similarly in respect of lost data, the whole Department was not impacted for 32 days. It was necessary for the ESP to roll back to clean back-up tapes to restore the data on several servers and this impacted different users for different lengths of time. As has been referenced in the report, the DoTRS Banyan Vines system was impacted as a result of a hardware fault which only surfaced when* [the ESP] *exercised a rarely used Banyan Vines system administration option. The particular fault could not be resolved by the ESP and had to be referred to the US based software and hardware providers who worked together to develop the necessary patch.* [The ESP]*] fully accepts responsibility as the ESP for the SLA's and* [the ESP] *did everything it could to understand the problem and support DoTRS. However, this is a situation where the ESP's capacity to anticipate the problem was limited by unusual circumstances and, in hindsight, a case for building a more discretionary approach to SLA compliance in the contract.'*

8.14 As noted, the Group 5 Agreement required that contracted service levels applied as from the date of handover.[183] Each Group 5 agency imposed the service credits calculated in accordance with the Agreement for all failures by the ESP to meet contracted service levels from handover in July 1999 to December 1999, the period of audit analysis. Those credits were significant, totaling some $960,000 and averaging about 18 percent of relevant service charges in each month.[184] Group 5 agencies advised ANAO that service credits continued to be incurred by the ESP at a comparable rate in the early part of 2000. In commenting on the proposed audit report, the Group 5 ESP advised ANAO in August 2000 that there had not been a final reconciliation of service credits, and that there were discussions taking place that may result in adjustments.

8.15 In May 2000, some eleven months into the Agreement, the Group 5 CMO advised ANAO that Group 5 agencies had yet to realise many of the benefits of outsourcing proposed by OASITO. The CMO advised that the experience of Group 5 had been that a higher than anticipated degree of 'micro-management' by agencies had been required to date, which had substantially reduced or negated the proposed benefits in terms of the ability of agency management to concentrate on business performance and strategic needs.

8.16 OASITO advised ANAO that the cost and performance visibility provided under the contractual arrangement tends to create the impression that service quality has deteriorated, or that service problems have increased, due to the formal identification and reporting of issues that previously went undetected or unreported. The Group 5 CMO advised ANAO that, although the Group agreed that outsourcing produces greater visibility of costs, it had not experienced any increase in visibility of problems. The CMO commented that, as suggested by OASITO, there had been an impression that service quality had deteriorated, but that the Group considered that deterioration to have been real, being the result of inadequate service delivery processes that had been admitted by the ESP and confirmed through surveys of agency staff who do not see the formal service quality reports.

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183 This requirement was reiterated to the ESP by the Group in it agreeing to full payment of the first transition payment on handover despite the ESP not fully achieving all specified transition milestones and deliverables. This was agreed on the basis of the ESP's undertaking that it had largely met the identified requirements.

184 Monthly service credits over the first six months of the Agreement accounted for an average of 70 percent of the maximum potential credits under the capping regime applicable.

8.17 The Group 5 CMO also indicated that, as at May 2000, the Group was yet to experience the benefit of improved responsiveness to agency requirements for substantial changes to IT infrastructure proposed by OASITO. The CMO advised ANAO that projects are central to implementing changes in the rapidly evolving IT environments of agencies but that project work had been a particular ongoing area of concern for the Group. The CMO advised that, in its view, the ESP had been less efficient at implementing infrastructure changes and project work than the in-house service model that had existed prior to outsourcing, and that project activity and changes of scope due to changing IT needs have the effect of eroding the benefit derived from the notion of guaranteed IT costs on a unit-rate basis.

Cluster 3

8.18 Unlike the approach taken under the ATO and Group 5 Agreements, the first twelve months of operation of the Cluster 3 Agreement saw significant change in the delivery of IT infrastructure services.[185] This added to the already complex task of simultaneously transitioning services in multiple agencies to the ESP. The delivery of mainframe services to agencies was consolidated and relocated from individual agency mainframes to the ESP's data centre in Sydney. In addition, the ESP was required to support AEC in its management of the 1998 Federal election some three months after handover. This delayed, in part, its planned transitional program.

8.19 The Cluster 3 CMO advised ANAO that the Agreement had enabled Cluster 3 agencies to achieve a number of significant infrastructure improvements and additions in a timeframe that would not have been achievable by agencies individually under the previous 'in-house' arrangements. In particular, the CMO noted that agencies had benefited from an enhanced scalability of infrastructure resources under outsourcing. For example, in the first twelve months of the Agreement, DIMA, the largest Cluster agency, trebled its mainframe capacity to service its major client/server application system. This was easily achievable under the unit-pricing provided under the Agreement. In that first year, the Cluster as a whole increased its volume usage of mainframe capacity such that, although spending more overall for mainframe services than previously, it was able to access an improved unit cost under the volume adjustment provisions of the Agreement.

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185 The Cluster 3 Contract Management Committee advised ANAO that a period for achievement of a steady state operation by the ESP could have been opted for, but would not have enabled agency priorities and commitments to be met in the time frames actually achieved.

8.20 There were also substantial infrastructure replacements and upgrades across the Cluster within a compressed timeframe, although there were considerable delays and project management difficulties in some cases. These included major desktop rollouts, PABX and handset refreshes, enhanced data net capacity and a significant upgrade of LAN infrastructure. The ability to achieve such upgrades had been a major incentive for a number of the agencies to join this first tender under the IT Initiative.

8.21 The Cluster 3 Management Committee (Cluster 3 MC) advised ANAO that the complexity of these projects, and the level of agency and ESP resources necessarily devoted to implementing them in a limited timeframe, materially influenced the strategies adopted by the Cluster to guarantee delivery to the Government. These factors also appear to have contributed to the significant service delivery difficulties Cluster agencies experienced at various times during this period. The disparate size, priorities and business requirements of Cluster agencies have also contributed to service difficulties (see Chapter 2).

8.22 Those difficulties were most apparent in regard to mainframe and desktop system availability, and the levels of service achieved in three areas considered by the Cluster to be critical to the effective delivery of services; that is, problem resolution; equipment and system moves, adds and changes; and closure on help desk calls. The Cluster imposed $2.4 million in service credits for services delivered in 1998-99, representing about 6 percent of invoiced service charges between October 1998[186] and June 1999. There has been improvement in the level of service delivered by the ESP since that time, with service credits imposed for the period July 1999 to March 2000 ($986,400) falling to about 3 percent of service charges.[187]

8.23 Other areas of service difficulty that had significant impact on agency operational efficiency were not subject to service credits. In particular, during the first year of service there was deep agency dissatisfaction with the ESP's management of system maintenance, backups and virus protection procedures and strategies.[188] Service levels,

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186 The Cluster had elected to allow the ESP an initial three month period of grace following handover in which it would not be liable to pay service credits.

187 In May 2000, Cluster 3 agency CEOs agreed to the application of a 45 percent discount to the service credits accrued by the ESP between July and December 1999 following consideration of anomalies identified by a joint agency/ESP working party review of the contracted service level and service credit regime.

188 In the case of AUSLIG, the agency was left with no virus protection at one stage, and DIMA's network required emergency remediation. In April 1999, some ten months after handover, the Cluster 3 CMO requested the ESP to provide its long- and short-term strategies for virus protection, including information on what virus protection existed and where.

and therefore potential service credits, were not specified for any of these areas of service. This issue has been addressed by the Cluster in a recent review of the contracted service levels (see Chapter 9).

8.24 Despite the difficulties experienced, however, the Cluster 3 MC advised ANAO that there had also been successful delivery of major business imperatives with a reliance on IT and telecommunications services, including:

- an extremely high level of support of the Federal Election and Referendum, made more complicated by the unpredictable timing of these events;
- support for new business initiatives and applications eg Kosovo and safe haven projects, unauthorised boat arrivals, Internet rollout across most agencies and the rollout of a major new application processing application in DIMA; and
- achieving a Year 2000 (Y2K) compliant environment within the Government's timetable across all agencies and lines of service.

8.25 The Cluster 3 MC considered that the ESP's performance in achieving these outcomes of critical importance to the agencies' business needs '*outweighed the under-achievement in some lower priority contractual requirements.*'[189]

8.26 In commenting on the proposed audit report, the Cluster 3 ESP advised ANAO that:

> *Given the complex and diverse nature of the infrastructure inherited by* [us], *and the large differences in agency businesses,* [we] *consider that the progress in replacement of substandard infrastructure, additional capacity, network and facilities and the remediation work undertaken for Y2K are significant achievements. Undertaking this work, in close consultation with Cluster 3 agencies to meet their business needs, had a higher priority than some other elements of the Agreement and were undertaken at substantial cost to* [us].
>
> *Unplanned activities ranging through a Federal Election, a Referendum and refugee and humanitarian relief exercises, also added to the volume and complexity of work.* [We] *believe it unrealistic to simply measure performance against a contract document written some time ago, rather than the living reality of its clients' – and Government's – dynamics.*

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[189] In February 2000, the Cluster 3 MC advised ANAO that: *The Cluster considers that generally the Cluster 3 Agreement is working well. There are a relatively small number of minor anomalies that are currently being resolved but this is understandable in a complex IT outsourcing arrangement.*

8.27 **Finding:** The outsourcing agreements considered in this audit have operated for relatively short periods. The longer-term effectiveness of the Agreements in delivering the expected benefits will be determined over their five year terms. However, the extent to which those benefits have been realised by agencies in the initial implementation phases of service delivery under the Cluster 3, ATO and Group 5 Agreements has been variable. Cluster 3, whose Agreement has been in operation since July 1998, advised ANAO that considerable progress has been achieved across a number of areas of importance to the Cluster.

8.28 Of the three Agreements, the transfer of responsibility for the outsourced services to the ESP appears to have proceeded with the fewest initial problems in the case of the single agency ATO Agreement. In that case, operational services were generally delivered to expected levels as from handover in late June 1999. However, the areas in which service delivery disruption did occur were areas of high end-user impact. Service credits of $1.1 million imposed by the ATO to June 2000 represented about 1.5 percent of service charges paid.

8.29 The experience of Cluster 3 and Group 5 highlighted that both agencies and tenderers underestimated the complexity involved in simultaneously transitioning to an outsourced provider the delivery of IT infrastructure services to a number of agencies. Group 5 experienced service delivery instability following handover to the ESP on 1 July 1999, with the severity and length of those problems varying between Group agencies. Group 5 agencies imposed service credits totaling some $960,000 and averaging about 18 percent of relevant service charges for all failures by the ESP to meet contracted service levels in the six months to December 1999, the period of audit analysis.

8.30 The first twelve months of operation of the Cluster 3 Agreement saw major change in the delivery of IT infrastructure services, with considerable progress achieved across a number of areas of importance to the Cluster. The complexity of these changes, and the level of agency and ESP resources devoted to implementing them in a limited timeframe, appear to have contributed to the significant service delivery difficulties Cluster agencies experienced at various times during this period. The disparate size, priorities and business requirements of Cluster agencies have also contributed to service difficulties. The Cluster imposed $2.4 million in service credits for services delivered in 1998-99, representing about 6 percent of invoiced service charges between October 1998 and June 1999. There has been improvement in the level of service delivered by the ESP since that time, with service credits imposed for the period July 1999 to March 2000 ($986,400) falling to about 3 percent of service charges. The Cluster 3 Management Committee advised ANAO that it considered that the ESP's performance in achieving outcomes of critical importance to the agencies' business needs *'outweighed the under-achievement in some lower priority contractual requirements.'*

Agency implementation issues

8.31 The level of understanding by the ESP of the agency environments for which it will assume control, and its preparedness for delivering services to contracted levels from the time of handover, are critical elements in achieving a transition that occurs with minimal disruption to agencies operational efficiency and effectiveness. That understanding and preparedness are developed initially through the due diligence processes undertaken by tenderers prior to submitting tenders and, more comprehensively, during the transition period between execution of the Agreement and handover of the services. The initial service delivery difficulties experienced by a number of agencies, particularly in Cluster 3 and Group 5, were influenced by aspects of these knowledge-transfer processes. OASITO advised ANAO that experience had shown that transitioning groups of agencies to an outsourced provider is more complex than the parties had expected, with the ESP heavily dependent on agency preparedness and cooperation in bringing about a smooth transition. Equally, ANAO noted that the agencies were reliant on ESP preparedness and cooperation.

Human resources transition

8.32 An important factor in the ability of the ESP to rapidly obtain an adequate understanding of agencies' technical and business environments is the extent to which existing agency staff take up positions with the successful tenderer, thereby providing continuity of corporate knowledge. Under the employee transition framework established for the IT Initiative, agencies had the option of selecting one of two transition approaches, Clean Break and Phased. All agencies in a particular group were required to exercise the same option. The Clean Break approach allowed for in-scope agency employees to accept voluntary redundancy and pursue employment with the successful tenderer, or any other employer, as they chose.[190] Agencies were required to remain at arm's length from the successful tenderer's recruitment of former agency employees. Under

[190] Under the Clean Break approach, employees who are made redundant are entitled to a severance payment of two weeks pay for each year of service up to a maximum payment of 48 weeks. Employees are also entitled to a notice period (or pay in lieu) . The Government had announced that, in the case of redundancies occurring after 1 July 1999, the employer component of employees' superannuation entitlements would be required to be preserved until retirement from the workforce. That measure will now come into operation as of 1 July 2000.

the Phased approach, the successful tenderer would be required to meet its additional staffing requirements initially from agency staff.[191]

8.33 A disadvantage with the Phased approach can be the potential for protracted negotiations, but agencies have more capacity to influence which staff transfer to the ESP. A disadvantage with the Clean Break approach can be that agencies have no control over the extent to which staff with required skills transfer to the ESP. In each of the tenders reviewed, the transfer of a significant proportion of existing staff was identified as important to the successful transfer of service delivery. However, in each case the Clean Break approach was adopted by the relevant agencies following consideration of various factors, including precedents within the Commonwealth, existing industrial agreements within agencies and informal advice on staff preferences.

8.34 Based on the responses to the Request for Information issued under the 1997 OGIT/DOF Evaluation, it had been considered that successful tenderers would require approximately 70 percent of existing agency staff to deliver the services. In the context of the risk assessment conducted as part of the tender process, the ATO had said that it was important that at least 70 to 80 percent of staff transferred to the successful tenderer. OASITO advised ANAO that the take up rate required in each tender will depend on the particular circumstances of that tender, and that it has put some emphasis on this issue in subsequent tenders.[192]

8.35 Under the Clean Break approach, agencies do not have specific information about the number of existing staff that were offered or accepted positions with the relevant ESP or its subcontractors. However, agency estimates indicate that, for a number of agencies, the number of existing staff transferring to the relevant ESP was considerably below that which agencies had considered desirable. In most cases, the estimated level of transfer represented about one-third of in-scope positions. This was influenced by a number of factors, including existing staff electing to retire early or to take up other employment opportunities.

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191 Agencies would be expected to negotiate with the ESP, and facilitate discussions between their staff and the ESP. Employees who did not receive or did not accept a job offer would be treated in accordance with the prevailing voluntary redundancy provisions. Employees taking up employment with the ESP would resign from the APS and be ineligible for a redundancy payment. Where, within six months of hand-over, the ESP recruited staff who had taken voluntary redundancy, the ESP would be required to pay the agency a sum of $25,000 for each employee recruited.

192 OASITO advised ANAO that its view is that it is not critical to achieve a 70 percent take up of agency staff.

8.36 In a number of agencies, the low levels of staff transfer contributed to operational difficulties following handover due to the loss of corporate knowledge and technical skills, especially in the operation of legacy systems. In the largest Cluster 3 agency, DIMA, the low numbers of existing staff transferring to the ESP was recognised as resulting in the loss of technical skills and expertise. The smaller Cluster 3 agencies, which had small IT staff numbers, had virtually no staff transferring to the ESP.[193] Group 5 agencies also experienced difficulties in this regard, particularly in relation to the transfer of skills in operating the Banyan Vines system in DoCITA and DoTRS. The low level of take-up achieved by the ATO ESP in respect of existing ATO help desk staff contributed to initial service delivery problems in that area.

Due diligence

8.37 International research has highlighted the importance of a comprehensive and rigorous due diligence process by both parties to establishing a successful outsourcing agreement.[194] Issues not appropriately resolved at the due diligence stage can provide management and service delivery difficulties. For example, the extent to which the due diligence process (and the subsequent transition phase) provides tenderers with complete disclosure of the design and operation of the existing infrastructure can have implications for the initial standards of service delivery provided.

8.38 Following the release of the Cluster 3, ATO and Group 5 RFTs, potential tenderers were provided with access to information about the agencies, their IT environments and internal performance information through a central data room, site visits, group briefings, formal interviews and a written question and answer process. This due diligence process was coordinated and managed by OASITO. Each RFT required that all due diligence be completed before the submission of tenders.

8.39 In providing feedback on the Cluster 3 process in April 1998, the Cluster Management and Negotiation Team indicated that the due diligence process could have been improved. In particular, it was noted that the purpose of the due diligence period was not communicated

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193 In commenting on the proposed audit report, the Cluster 3 ESP advised ANAO in August 2000 that: *'The exercising of the Clean Break approach for existing staff by agencies is a further major issue in achievement of a timely, cost-effective, proper transition. Given the disparate nature of the business of agencies in Cluster 3,* [it] *does not understand the logic of all agencies having to exercise the same option and considers this to have had a detrimental effect upon both agencies and* [itself].'

194 Research Note, Key Issue Analysis, *Six Tips and Techniques for Managing Outsourcing Deals*, R, Terdiman, GartnerGroup, 23 April 1998.

effectively to industry and that the period was not used to its best effect. This was subsequently reflected, to some extent, in the initial understanding of the successful tenderer of the existing agency infrastructure and operations, and of the equipment transferred to it. In commenting on the proposed audit report, the Cluster 3 ESP advised ANAO that: '[It] *agrees completely that the nature and purpose of the due diligence period was **not** adequately communicated to industry and the period was not used to good effect.'*

8.40 In March 2000, OASITO advised ANAO that, as Cluster 3 was the first time a 'cluster' arrangement had been implemented, it was required to develop a cluster-based tender process from scratch. OASITO advised that lessons learned from that tender were carried forward to future tender processes, but that it also considered the due diligence process to have been fundamentally sound. However, some similar areas for improvement appear to have arisen in the ATO and Group 5 tenders, particularly the extent to which tenderers obtained or were provided with complete information regarding the existing infrastructure and its operation (including, for example, relevant system designs, internal patches etc), and the identification of an agreed baseline of the existing equipment transferred to the successful tenderer.

Transition period

8.41 In each case, the successful tenderer's understanding and knowledge of the existing infrastructure and agency business environments was more fully developed during the transition period between execution of the outsourcing Agreement and handover of the services. The formal transition period was three months for both Cluster 3 and Group 5[195] and eleven weeks for the ATO. The ESP was then required to deliver services to the contracted levels as from the commencement of the Agreement. The initial service standards delivered suggest that, in some cases, either the period allowed and/or the level of resources committed by ESPs and agencies to ensuring there was a sound understanding of agency business and technical environments may not have been adequate for the task involved, particularly in the multi-agency groups. This factor was exacerbated by the due diligence and staff transition issues discussed above.

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[195] In the case of Group 5, ten weeks elapsed between contract execution and the handover of services. However, the Group 5 Contract Management Office advised ANAO that the Group and the preferred tenderer always envisaged that there may be a delay in finalising and signing the contract. As such, informal agreement was reached with the preferred tenderer that transition would commence before contract signature, allowing a three month transition.

8.42 OASITO advised ANAO that it considers the ten to twelve week period from contract signing to operational handover appropriate for projects of the size and complexity of Cluster 3, ATO and Group 5, having regard to the business needs and organisational requirements of those agencies at that time, and the risks associated with longer handover periods. OASITO also advised that there is no required time frame for transition under the Initiative, and that transition periods were determined by agreement with the affected agencies based on their business priorities and other needs.

8.43 The Group 5 CMO advised ANAO that, although short transition periods are not necessarily impractical, they do require that a greater resourcing effort be applied in order to be effective. DoTRS noted that it would suggest that, in future, tenderers be provided with more time to undertake due diligence and raise issues with agencies through clarification questions. DoTRS further commented that, given its experience with service provision in the first four months of Group 5, some form of phased transition could be utilised in future processes.

8.44 In commenting on the proposed audit report, the Group 5 ESP advised ANAO that:

> *All parties in negotiations were concerned about the length of transition. Soft landings were discussed at negotiations. The ESP agreed to compress the period in good faith. However, given the importance of transition to user acceptance and that transition uncovers more unforeseeable disruptions to plan than any other project phase, a longer transition period in Group 5 would have made a difference to the ESP's performance and to customer satisfaction.*

8.45 In advising Group 5 agencies on contract management arrangements, the DIMA contract management office recommended that agencies allow as long a transition period as possible, and recognise that the true transition to a steady state is likely to take longer than any contractually recognised transition period. This was based upon the experience of agencies in Cluster 3. It was also acknowledged within DIMA that the transitional period envisaged by the contract markedly underestimated the time it would take the ESP to achieve acceptable service levels. In commenting on the proposed audit report, the Cluster 3 ESP advised ANAO that:

> [It] *believes that the complexity and length of transition was seriously underestimated. This factor is a significant contributor to any perceived shortcomings in a strictly literal interpretation of performance and the Agreement. It is simply not practical for a central agency like*

OASITO to determine realistic and appropriate parameters for a disparate group of operating agencies. The sound understanding required by both sides cannot be externally determined and needs to remain a matter of flexibility and negotiation under operating circumstances.

8.46 It is in the interests of both the Commonwealth and ESPs for transition timeframes to be realistic; for the ability of ESPs to deliver services to an appropriate standard as from handover to be thoroughly assessed during transition; and for agencies to form realistic expectations of initial service delivery to support the development of appropriate contingency and risk management plans, as well as the preparation and education of agency users of the services to be delivered. A draft Contract Management Guide released by OASITO in January 2000 discusses a number of these issues, and recommends that agencies place particular focus on areas such as the development of change management strategies; tracking contractual obligations; and the pro-active management of risks, end-user expectations and staff separations. In particular, the Guide highlights the importance of agencies alerting the successful tenderer to any deficiencies in the existing systems, processes and documentation, especially where the relevant agency staff are unlikely to transfer to the ESP.

8.47 **Finding:** The number of existing agency staff that took up positions with the Cluster 3, ATO and Group 5 ESPs was considerably below that which agencies had considered desirable in order to maintain continuity and the transfer of knowledge of agency infrastructure. In most cases, the estimated level of transfer represented about one-third of in-scope positions. In the context of the risk assessment conducted as part of the tender process, ATO had said that it was important that at least 70 to 80 percent of staff transferred to the successful tenderer. In a number of agencies, the low levels of staff transfer contributed to operational difficulties following handover due to the loss of corporate knowledge and technical skills, especially in the operation of legacy systems.

8.48 Areas for improvement in the due diligence and transition processes undertaken included the extent to which tenderers obtained or were provided with complete information regarding the existing infrastructure and its operation (including, for example, relevant system designs, internal patches etc), and the identification of an agreed baseline of the existing equipment transferred to the successful tenderer. The formal transition period between the execution of the Agreement, and the handover of services to the successful tenderer was three months for both Cluster 3 and Group 5, and eleven weeks for the ATO. The initial service standards delivered suggest that, in some cases, either the period allowed and/or the level of resources committed by ESPs and agencies to ensuring there was a sound understanding of agency business and technical environments may not have been adequate for the task involved, particularly in the multi-agency groups.

Agency savings outcomes

8.49 Monitoring the extent to which the savings projected in tender evaluations are realised under IT outsourcing Agreements will become increasingly complex over the term as agencies' requirements and technological solutions change. It will also become increasingly difficult for agencies to estimate the cost that would have been incurred to deliver those services internally.

8.50 The Cluster 3 MC advised ANAO that, in its view, substantial outcomes had been achieved for the Commonwealth under the Cluster 3 Agreement at a cost which, on the available evidence, was consistent with the contract and lower than the internal costs the Commonwealth would have had to incur for similar services. The Cluster 3 CMO estimated the savings realised in the first year of its Agreement by comparing the service charges and direct contract management costs incurred with the agency cost baseline used in the tender evaluation, which it normalised to reflect the actual volumes consumed during 1998-99.

8.51 The Cluster 3 CMO identified savings of $5.8 million, or 12 percent of the normalised agency baseline.[196] This was about 80 percent of the rate of first year savings forecast in the tender evaluation for the agencies considered in the Cluster 3 CMO's analysis. Relevant agencies were expected to accrue savings of 15 percent of the agency cost baseline ($6.4 million) in the first year for the equivalent costs (see Figure 8.1).[197]

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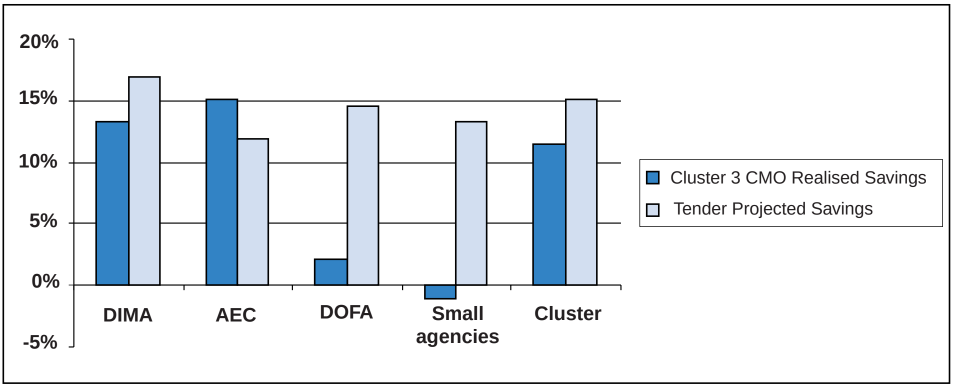
196 The Cluster 3 CMO's analysis excluded DOFA bureau customers. Savings identified included reductions in payments for service credits imposed.

197 The savings model used in the tender evaluation to project first year savings included estimated voluntary redundancy (VR) payments and the payment to agencies by the ESP for existing equipment. The Cluster 3 CMO's analysis did not include these costs in either the normalised baseline or service charges considered. Taking those costs into consideration, the tender evaluation projected savings for the first year of the Agreement of 23 percent ($9.88m) for the agencies considered by the CMO. Including the equivalent items in the CMO's savings analysis results in first year savings realised across the Cluster of 13 percent of the normalised agency baseline ($6.7 million). A significant factor in the variance from expected savings is that actual DIMA VR payments were 3.5 times the $1 million estimate used in the evaluation.

Savings were identified for all but one agency, but at a generally lower rate than expected.[198]

Figure 8.1

Cluster 3 CMO analysis of normalised savings realised in 1998-99 compared to rate of savings projected for 1998-99 in tender evaluation[199]



Source: Cluster 3 CMO analysis, Cluster 3 IT Services Evaluation Report and ANAO analysis

8.52 The quantum of service charges incurred by Cluster 3 agencies in the first year of the Agreement differed from the charges projected by the ESP in its tender. This was due to a number of factors, including that:

- the volume of services required by agencies differed from the projected volumes on which the tenderer based its projected charges;
- agencies requested additional services not identified in the RFT and, therefore, not covered by the ESP's tendered price;
- errors were made in the calculation of projected mainframe costs;
- incorrect assumptions were made as to the services that would be covered by the service charges included in the Agreement[200]; and
- services, such as the roll-out of network upgrades, were not completed in 1998-99 as expected and, therefore, were not included in service charges in that year.

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198 IP Australia was projected to accrue savings of $220,000 (34 percent) in year one, but realised a cost premium of $209,000 (24 percent) over the normalised baseline. This was primarily due to an error in the tender evaluation which understated mainframe costs under outsourcing. IP Australia represents less than 3 percent of projected mainframe service charges over the term. Identified savings for AEC were greater than anticipated, partly due to a delay in the rollout of its desktop upgrade.

199 'Small agencies' consists of AGAL, AUSLIG and IP Australia.

200 In April 2000, the Cluster 3 MC advised Cluster 3 agency heads that the ESP and the Cluster were concerned that some areas of the Agreement lacked clarity and were not delivering their intended outcome. In terms of pricing issues, it was noted that this lack of clarity manifests itself in a mix of problems that appear to unfairly advantage the Cluster in some cases, and the ESP in others. A review of these aspects of the Agreement is planned, with the expected outcome being more clarity and certainty in the management of the Agreement.

8.53 Information was not available to enable comparable analysis of the savings realised under the ATO and Group 5 Agreements. At the time of audit, the Agreements had not yet been in operation for a full year and, due to delays in the reconciliation of invoiced charges, full cost information for the period of operation was not available. In February 2000, the ATO advised ANAO that it would be commissioning an external consultant to conduct a comprehensive cost analysis of the relevant services after handover for comparison with costs before handover to identify the level of any savings achieved through the outsourcing initiative. The ATO advised that the timing of the engagement was dependent upon the ATO and ESP resolving problems associated with telecommunications invoicing. As at June 2000, the ATO had yet to pay telecommunications invoices for the first year of the Agreement.

8.54 ANAO understands that Group 5 does not intend to monitor actual cost savings against those projected in the tender evaluation. The Group 5 CMO advised ANAO that the Group believes that the process of measuring cost savings is unreliable and more likely to be misleading than helpful. The CMO considered that the absence of a continued in-house delivery model and the likelihood of additional projects being required of the ESP meant that there were serious difficulties in determining savings through the term of the Agreement. The CMO argued that, on that basis, it is difficult to justify that resources should be devoted to this, particularly where it *'will not assist (and may distort) appropriate decision-making by contract managers and government'*.

8.55 **Finding:** Analysis conducted by the Cluster 3 CMO assessed that, based on service fees and direct contract management costs, savings of $5.8 million or 12 percent were realised across the Cluster in the first year of the Agreement. This was about 80 percent of the rate of financial savings forecast for the same agencies in the tender evaluation for the corresponding period and costs. That analysis excluded consideration of transitional costs.

8.56 Information was not available to enable comparable analysis of the savings realised under the ATO and Group 5 Agreements. In February 2000, the ATO advised ANAO that it would be commissioning an external consultant to conduct a comprehensive cost analysis of the relevant services after handover for comparison with costs before handover to identify the level of any savings achieved through the outsourcing initiative. ANAO understands that Group 5 does not intend to monitor actual cost savings against those projected in the tender evaluation.

Agency performance management and review

8.57 The formalised performance reporting generally required of ESPs is an important tool for the effective management of the contract by agencies. Under each Agreement, the ESP is required to report on its performance at least monthly and in as much detail as reasonably required by the relevant agencies to assess its performance. Each ESP is also required to use appropriate measurement and monitoring tools and procedures to measure its performance accurately. Each Agreement provides the agencies with the capacity to have the ESP's performance reporting independently audited and verified.

8.58 In many cases, the reporting required of ESPs has the potential to provide greater visibility of performance than was previously available under internal service delivery. As noted, OASITO identified a high degree of visibility into IT operating costs and service quality as a benefit to agencies under outsourcing. However, under each of the Agreements reviewed there have been extended delays in the provision by the ESP of accurate and adequately substantiated performance information.

8.59 There were delays in the receipt of some service level reports from the ATO and Group 5 ESPs for some months following handover. This was in part due to delays in the provision of the invoices intended to accompany such reports. In the case of Group 5, the ESP advised ANAO that the core service level reporting was in place from August 1999, the second month of operation, but that there were delays with supplementary reporting and on-line access to the ESP's help desk database. Delays in the roll out by the Group 5 ESP of the remote management system planned to facilitate performance reporting affected its ability to automate its service level reporting. That roll out was not substantially completed until some months after handover, with automated performance reporting not yet available in respect of three of the five agencies.[201]

[201] The Department of the Prime Minister and Cabinet advised the ESP that it would not accept roll out of the remote monitoring system on its network until the relevant security aspects had been approved by the Defence Signals Directorate . This approval could not proceed until the system had been adequately documented. That process is yet to be completed. The Group 5 ESP was unable to configure the Banyan Vines operating system used in DoTRS and DoCITA to accept the remote monitoring system. Accordingly, it will unable to automate its performance reporting for those agencies until the Banyan Vines system is replaced, which is planned for 2000.

8.60 The ATO ESP was yet to provide full supporting information for the performance reported by it some twelve months into the Agreement. As a result, as at June 2000 the ATO identified all service credits paid to that time as interim only and retained the potential to impose further service credits when full substantiation of the ESP's performance was possible. In August 2000, the ATO ESP advised ANAO that:

> [It] *provided the ATO with the first service level reports in September 1999. On receipt of these reports the ATO indicated that it required additional information to substantiate these reports.* [It] *worked with the ATO to identify the most appropriate information and how this should best be reported. As this exercise was given a lower priority than meeting the immediate needs of the Tax Office, including the significant changes that were required to implement the GST, we agreed that interim service credits would be calculated and deducted from invoices until this exercise was completed.*

8.61 There was also an extended delay in the provision by the Cluster 3 ESP of performance information that the Cluster considered reliable and accurate. Addressing this issue has required the application of significant levels of resources by both the Cluster 3 CMO and Cluster agencies, with the CMO acknowledging in June 1999 that the Cluster had underestimated the effort required to manage performance reporting.

8.62 During the first year of service delivery following handover in July 1998, Cluster 3 agencies identified a number of areas in which the ESP was not providing appropriate performance measurement against particular service levels, and expressed concerns regarding the accuracy and completeness of the performance reporting provided. The Cluster and the ESP had agreed in December 1998 that many of the ESP's measurement methodologies for the various service levels needed to be improved. However, this did not result in significant improvement. In June 1999, the Cluster reiterated its requirements for data that enabled validation of the ESP's service level measurements. The ESP provided the Cluster agencies with presentations on the measurement processes used by it between July and September 1999, over one year after the Agreement commenced.[202]

[202] A consultant engaged by Cluster 3 in June 1999 to review the service levels under the Cluster 3 Agreement noted that the method by which performance against each service levels is to be measured, when it is to be measured and by whom should be specified.

8.63 In November 1999, the Cluster 3 CMO advised ANAO that, subject to further development of performance measurement for the midrange platform, the Cluster was now generally satisfied with the ESP's performance reporting methodology and measurement process, which would be periodically audited and verified by the CMO. In April 2000, the Cluster reported that significant changes by the ESP in the management of reporting had resulted in much more rigorous data collection and accounting procedures.

8.64 In commenting on the proposed audit report, the Cluster 3 ESP advised ANAO that:

> *The nature of performance information is dependent upon operating experience, practicality and the commercial availability of appropriate tools. This is an area where there are gaps between the expectations of both sides and where rigid contractual parameters are unrealistic. Again it is a matter for experience.*

8.65 In April 2000, OASITO acknowledged that, during the settling in phase, the Cluster 3 and Group 5 ESPs had struggled to implement the rigorous performance reporting regimes required under the contracts, and that it had taken time for the desired level of visibility to become established. OASITO also advised that it had learned a number of lessons from Cluster 3, Group 5 and subsequent contracting processes. In particular, it had been expected that tenderers would highlight in their bids or in negotiation if they believed the Commonwealth's requirements during the initial settling in phase were too onerous. It was noted that, for a number of reasons, tenderers generally did not do so in the early bid processes. OASITO further advised that, in assessing, during the tender evaluation phase, the capability of tenderers to provide performance reporting, evaluation teams must rely to some extent on the technical documentation provided, previously demonstrated capability of contractors, reference sites and market knowledge or research on the proposed tools.

8.66 OASITO advised that the Commonwealth has taken account of the experiences of Cluster 3 and Group 5 in moderating expectations regarding the pace at which new reporting processes can be implemented, particularly having regard to the impact of unforeseen circumstances on agency service priorities. However, OASITO also considered that even a protracted delay in the implementation of service measurement and reporting processes should not be viewed as a major problem, given that agencies did not measure or report many of the services prior to outsourcing, and that performance problems that have a direct impact on agency businesses are immediately apparent without the need for formal reporting processes.

8.67 The Group 5 CMO commented that performance reporting from early in the contract should not be unachievable and noted that the comparison with an in-house service delivery model is not applicable as service level reporting is one of the key tools for managing the outsourcer. It also commented that, in an in-house service model, effective mechanisms are available to manage performance that don't depend on service level reporting.

Audit of ESP performance and information

8.68 The OECD Best Practice Guidelines for Contracting Out Government Services recommend that, when performance information originates from the ESP, it should be audited to ensure its accuracy.[203] Despite its reservations regarding the performance information provided by the ESP, Cluster 3 did not commence its first audit of the performance data provided until January 2000, some eighteen months after handover.

8.69 The Cluster 3 CMO indicated to ANAO that, given the known inadequacies in the ESP's existing performance reporting processes, it had not been considered that an audit of those process would improve the Cluster's position. ANAO notes, however, that some 14 months into the Agreement, reporting by the Cluster 3 CMO on service credits accrued by the ESP continued to carry a caveat that no verification of performance had been possible to that time, and that the CMO's confidence in the ESP's performance measuring methodology was low. This was despite repeated requests from the Cluster for additional information from the ESP regarding the performance information being reported. This highlights the importance of agencies obtaining reliable performance information to support the exercise of their statutory resource management responsibilities.

8.70 The significant efforts by the Cluster over a number of months to achieve substantial improvement in this area is acknowledged. ANAO considers, however, that it would have been of benefit to the agencies to have introduced independent review of the performance reported by the ESP earlier in the implementation of the Agreement as a normal part of prudent contract management.[204] This may have provided an incentive for improved responsiveness by the ESP to the Cluster's concerns.

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[203] *Best Practice Guidelines for Contracting Out Government Services*, Organisation for Economic Co-operation and Development, 14th Session of the Committee, Chateau de la Muette, Paris, 30-31 October 1996, p 7.

[204] For example, where Cluster agencies had retained the capacity to separately measure ESP performance, discrepancies in reported performance were identified and raised with the ESP. This highlighted the importance of some form of external verification of ESP-supplied performance information.

8.71 This has been the approach taken by Group 5 which, although not considering that there were major errors in the ESP's performance reporting, commenced its first audit of the ESP's service level reporting in early 2000, some six months after handover. The Group 5 CMO advised ANAO that the Group supports the view that audit of contractor's performance reporting is valuable early in the term of the contract. As at June 2000, the ATO had yet to undertake external verification of the performance information reported by the ESP.

8.72 In addition to the performance information provided by the ESP, the Cluster 3, ATO and Group 5 Agreements provide the relevant agencies, or their internal or external audit representatives, with the right to audit or inspect the ESP's performance of and/or compliance with its contractual obligations. As at June 2000, Cluster 3 was yet to perform audits or inspections under the terms of the Agreement of aspects of the ESP's contractual obligations other than performance information. A paper proposing the implementation of an audit program to support the management of the Agreement was presented to the Cluster 3 MC in September 1999, some fifteen months after its commencement.

8.73 The ATO Internal Audit Branch established a program of audits of various aspects of the implementation of the ATO Agreement, with the first audits completed some six months after the Agreement commenced.[205] As at June 2000, Group 5 had yet to develop a strategy for the independent review of aspects of the ESP's compliance with contractual obligations other than performance reporting. ANAO considers that the formulation and implementation of an audit program early in the term of an IT outsourcing arrangement would assist agencies in the verification of the ESP's compliance with contractual obligations and be an aid to effective contract and resource management.

8.74 This would also be assisted by the development and maintenance of a comprehensive list of the contractual obligations of each party under the Agreement. The best way to ensure all aspects of contract administration will be properly performed is to prepare an administration plan that isolates relevant tasks and describes when each task has to be performed.[206] This is supported by the OASITO draft Contract

205 As at June 2000, ATO internal audit had completed reviews of the transfer of assets to the ESP, and the implementation of the insurance provisions of the ATO Agreement. As a result of the latter review, ATO internal audit recommended that the ATO CMO obtain legal advice regarding the compliance of the ESP's public liability insurance policy with the requirements of the Agreement. ATO advised ANAO that action in regard to that recommendation was in train as at June 2000.

206 Legal Practice Briefing No 27, *Commonwealth IT Outsourcing*, Attorney-General's Department, 28 August 1996,

Management Guide, which noted that customer practices commonly found in successful outsourcing relationships included the establishment, within three months after handover to the ESP, of management strategies relating to performance monitoring and verification and the conduct of audits; and the development and maintenance of a checklist of deliverables and deadlines for each participant over the course of the contract.

8.75 At the commencement of the ATO Agreement, the ATO CMO established a comprehensive listing of deliverables from the Agreement detailing the party responsible, date for delivery and current status, which is subject to ongoing monitoring. A list of contractual obligations was not developed by Cluster 3 until May 1999, some eleven months after handover. In February 2000, the Group 5 CMO advised ANAO that the Group was in the process of doing a detailed review of the Agreement to prepare a comprehensive set of deliverables. It was noted that lists of key deliverables had already been developed as a basis for programming the Group's contract management resources.

8.76 **Finding:** Each Agreement provides the agencies with the capacity to have the ESP's performance reporting, and other aspects of its contractual obligations, independently audited and verified. Significant delays were experienced by Cluster 3, Group 5 and the ATO in obtaining from the relevant ESP substantiation material to enable them to verify the performance reported. OASITO advised ANAO that the Commonwealth has taken account of the experiences of Cluster 3 and Group 5 in moderating expectations regarding the pace at which new reporting processes can be implemented, particularly having regard to the impact of unforeseen circumstances on agency service priorities.

8.77 Cluster 3 commenced its first audit of performance data provided by the ESP in January 2000, some eighteen months after handover. At June 2000, the Cluster was yet to undertake audits of other aspects of the ESP's contractual obligations. The ATO Internal Audit Branch established a program of audits of various aspects of the implementation of the ATO Agreement, but as at June 2000, had yet to undertake external verification of the performance information reported by the ESP. Group 5 commenced an audit of the ESP's performance reporting some six months after the Agreement commenced, but has yet to develop a strategy for the audit or review of other aspects of the ESP's performance or compliance with contractual obligations. ANAO considers that the formulation and implementation of an audit program early in the term of an IT outsourcing arrangement would assist agencies in the verification of the ESP's compliance with contractual obligations and be an aid to effective contract and resource management.

Recommendation No. 16

8.78 ANAO *recommends* that, to assist in the verification of external service providers' reported performance, its compliance with contractual obligations, and as an aid to effective contract and resource management, relevant agencies consider the formulation and implementation of an independent review and evaluation program as soon as practicable in the term of an IT outsourcing arrangement.

8.79 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response:*** **Agree.** Agencies will continue to develop mechanisms and processes to ensure effective contract management, having regard to the costs and anticipated benefits of introducing additional layers of review.

9. Contract Management

This chapter discusses aspects of contract management of IT outsourcing agreements.

Overview

9.1 Effective contract management plays an important part in achieving successful outcomes under an IT outsourcing arrangement. To ensure they obtain value-for-money from the arrangement, it is important that agencies develop new and enhanced contract management skills. To ensure agencies' strategic, technical and business continuity requirements are adequately addressed by the ESP, it is equally important to retain within agencies appropriate technical skills and corporate knowledge. This will enable agencies to effectively define on-going requirements and evaluate the cost-effectiveness of solutions proposed by the ESP. The initial implementation phases of the Cluster 3, ATO and Group 5 Agreements have provided valuable experience and lessons that can be applied to enhance the efficiency and effectiveness of the future implementation and management of IT outsourcing Agreements (including the linkages with broader IT governance issues) for both agencies and ESPs.

9.2 The extent of continuity of agency personnel involved in the tender process in the subsequent management of the Agreement is an important influence on the ability of agencies to effectively manage the contract.[207] This continuity has largely been achieved under the Cluster 3, ATO and Group 5 Agreements for both coordinated group management and individual agency contract managers and has had clear benefits to those agencies. The challenge for agencies will be to retain that corporate knowledge as personnel changes occur over the term of the Agreement.[208]

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207 The August 2000 DOFA whole-of-government response to the proposed audit report commented that: *Agencies agree with ANAO's view in relation to the retention of appropriately skilled staff with corporate knowledge. A number of agencies have been successful in retaining key staff that were heavily involved in the tendering and evaluation processes, who have the strategic, technical and corporate knowledge to provide adequate business continuity for their departments. Agencies have retained these staff by providing* [Australian Workplace Agreements] *and committing resources to provide training in contract management and in ongoing IT developments.*

208 A number of DIMA personnel involved in the tender evaluation took up positions in the Cluster 3 CMO. This provided a retention of DIMA-related knowledge of the tender process, but limited the capacity of staff with that knowledge to be involved in the management of the contract on a day-to-day basis from the DIMA perspective. DIMA also did not retain any technical personnel to assist in the management of the Agreement, including the framing of project specifications for delivery by the ESP. These factors, combined with the initial service delivery problems encountered, created significant difficulties for the DIMA contract management area and diminished its capacity to focus on strategic contract management issues for some time after handover.

9.3 As more IT outsourcing Agreements are implemented across the Commonwealth, an increasing body of contract management experience is being developed within the Commonwealth. A Commonwealth IT outsourcing contract managers' forum has been established. In January 2000, OASITO released a draft Contract Management Guide which was developed in conjunction with representatives from agencies with IT outsourcing experience. OASITO advised ANAO that, in order to ensure the advice contained in the guide was effectively communicated to agencies, it had conducted several contract management seminars for the Health Group. An outcome from those seminars was that OASITO agreed to establish a high level forum for consideration of strategic outsourcing issues and the mechanisms used to address them across the Commonwealth.

9.4 Based on the experience of Cluster 3, ATO and Group 5, key areas on which agencies should place particular focus in order to enhance the effectiveness of the management of IT outsourcing arrangements, as outlined in this chapter, include:

- identification and management of 'whole-of-contract' issues, including retention of corporate knowledge, succession planning, and industrial relations and legal issues;
- putting in place a management regime and strategy that encourages an effective long-term working relationship with the ESP, while maintaining a focus on contract deliverables and transparency in the exercise of statutory accountability and resource management requirements;
- defining the service levels and other deliverables specified in the Agreement so as to unambiguously focus the management effort of both the ESP and agencies on the aspects of service delivery most relevant to agencies' business requirements;
- the ESP's appreciation of, and ability to provide, the invoicing information, including substantiation material, required by agencies to support their statutory accountability and resource management requirements; and
- the establishment of effective strategies for the monitoring of the ESP's compliance with contractual obligations in regard to security and privacy.

9.5 The August 2000 DOFA whole-of-government response to the proposed audit report commented that:

> *The Report appears to focus heavily on process and the presence or absence of documentation in support* [of] *contract management decisions. Whilst analytical material supporting management decisions can enhance transparency for audit purposes, that material is not*

necessarily helpful in achieving better outcomes in terms of IT service delivery, particularly when issues are complex and time frames for decision are short. We are concerned that the approach taken by ANAO in this area could, if implemented fully, impede effective and responsive decision making. The Report should take a more pragmatic position regarding documentation of decisions.

The Report fails to note that agencies in seeking to improve service delivery have moved beyond traditional contracting models. The Report has not examined the alternative mechanisms that agencies are adopting to manage collaborative relationships with their service providers that will deliver high-quality solutions capable of meeting evolving needs. The service agreement should be seen as a framework that provides guidance and a clear direction for the application of management strategies to ensure business outcomes are achieved.

9.6 **ANAO comment:** ANAO recognises that contractual performance is maximised by a cooperative, open relationship between the parties. However, cooperation is not a substitute for a sound contractual relationship. In order to protect the Commonwealth's interest, it is essential that there is a sound understanding of what is expected between the parties and the basis for decisions taken. Such consideration must necessarily be undertaken within the context of appropriate public sector resource management practices, including the need for agencies to be able to demonstrate compliance with their obligations under the FMA Act to manage the affairs of the agency in a way that promotes proper use of Commonwealth resources, unless there is a Government direction that exempts such obligations on the basis of broader benefits to the community. Documentation, which is fit for its purpose, supports this as it assists effective decision making and aids accountability.

Transaction costs

9.7 As a single agency Agreement, the ATO has established an internal contract management structure. This role becomes more complex in a grouped environment. Both Cluster 3 and Group 5 have put in place a contract management structure comprising a management committee,[209] central contract management office (CMO) and contract management cells within each agency. Agency contract managers are responsible for the day-to-day interactions with the ESP, monitoring the performance of the ESP, and the referral to the CMO of issues that affect the Agreement.

[209] The management committees comprise appointed members from each of agency and operate under Memorandums of Understanding between the agencies, with OASITO and DoCITA (in respect of industry development) having observer status. The management committees have overall responsibility for ensuring the relevant ESP complies with the Services Agreement, but may delegate any of its responsibilities to the CMO or other sub-committees.

9.8 Cluster 3 has adopted a more centralised approach to contract management than have the Group 5 agencies. This is reflected in the resourcing of the two offices, with the Cluster 3 CMO comprising six full-time resources compared to two in the Group 5 CMO. Both provide a point of central co-ordination for the management of major issues with the respective ESP, as well as secretariat support to the respective management committees. The Cluster 3 CMO performs more of the hands-on contract management functions than does its Group 5 counterpart, particularly in regard to invoicing and performance reporting processes.

9.9 The appropriate approach to structuring the contract management function for outsourcing agreements servicing multiple agencies will depend upon the relevant agencies' assessment of the costs and benefits of the options available. The Group 5 CMO advised ANAO that the Group does not consider that there is any evidence to suggest that clustering reduces contract management costs. On the contrary, the CMO advised that, although it has no firm evidence, the Group suspects that clustering increases costs because of the extra overhead involved in internal Group coordination on top of normal contract management functions. The Cluster 3 Management Committee (Cluster 3 MC) advised ANAO that a lesson from its experience is that the CMO plays a valuable role in day to day contract management.

9.10 Industry experience with IT outsourcing has been that organisations often underestimate the management effort and resources that will be required to effectively manage the outsourcing agreement, particularly in the initial implementation phase. To varying degrees, this has been the case in Cluster 3, ATO and Group 5, with the initial contract management effort required exceeding the expectations of many agencies, with the increased management effort and transaction costs occurring at both the operational and senior executive levels. Particularly in the case of Cluster 3 and Group 5, many of these latter costs resulted from the need for senior management to focus on the delivery of the relevant services to an extent not previously experienced in order to address initial service delivery problems. These transaction costs are not fully captured in the overall reported costs of managing the contracts. In some agencies, additional resources were required to conduct greater than anticipated verification effort on invoices and performance information. This requirement may reduce as the invoicing and performance reporting processes are bedded down.

9.11 Contract management costs are typically identified as a percentage of service charges. In the case of Cluster 3, overall reported contract management costs in the first year of the Agreement were 4.8 percent of service charges.[210] Projected first-year contract management costs for the ATO and Group 5 were 4.2 percent and 7.4 percent respectively.[211] Within the multi-agency groups, there was considerable variance in the relative commitment required between larger and smaller agencies. In Cluster 3, the reported contract management costs ranged from a low of 3.7 percent for the largest agency (DIMA), to a high of 23.3 percent for the smallest participant (IP Australia).[212] In Group 5, the range was narrower, with the lowest being DoCITA at 5.5 percent and the highest, DoTRS, at 8.2 percent. On this basis, it is apparent that the transaction costs incurred by smaller agencies in relation to the value of services received can be considerable in comparison to the larger agencies.

9.12 **Finding:** The initial contract management effort required in respect of the Cluster 3, ATO and Group 5 Agreements has exceeded the expectations of many agencies, with the increased management effort and transaction costs occurring at both the operational and senior executive levels. Many of these latter costs resulted from the need for senior management to focus on the delivery of the relevant services to an extent not previously experienced in order to address initial service delivery problems. These transaction costs are not fully captured in the overall reported costs of managing the contracts. In the case of Cluster 3, reported contract management costs in the first year of the Agreement were 4.8 percent of service charges. Projected first-year contract management costs for the ATO and Group 5 were 4.2 percent and 7.4 percent respectively. Within the multi-agency groups, the transaction costs incurred by smaller agencies in relation to the value of services received were considerable in comparison to the larger agencies.

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210 Calculated on the basis of actual reported contract management costs and service charges for 1998-99.

211 Calculated on basis of budgeted contract management costs and estimated service charges for 1999-00.

212 The reported contract management costs for the other small agencies in the Cluster were 13.9 percent for AGAL and 9.7 percent for AUSLIG.

Service credits

9.13 Service levels and service credits are contractual mechanisms by which the ESP's performance is regulated. They form part of a broader contract management framework. Establishing service levels for the first time as part of the outsourcing process is difficult, and requires judgements about what level of service at the technology level will meet agencies' business needs, and how those levels should best be measured and reported. These judgements should be reviewed and service levels adjusted in the light of actual experience through implementation of the outsourcing relationship. This process may require some flexibility to ensure that service levels are focussed on aspects of service delivery that are most relevant to agencies' business needs. Similarly, service credits are intended to provide a flexible mechanism to maintain focus on key components of the ESP's service delivery consistent with agency business requirements.

9.14 The Cluster 3, ATO and Group 5 Agreements provide the relevant agencies with a discretion as to whether to impose service credits accrued as a result of the ESP's contractual non-performance.[213] The Cluster 3 and ATO Agreements place no limitation on the timeframe in which the agencies must make a decision on the application of service credits.[214] The Group 5 Agreement requires the Group to apply service credits within a specified period after service failure, or be deemed to have waived the right to the service credit. Agencies also have a discretion as to the form in which the 'payment' of service credits from the ESP will be received.

9.15 Service credits are included in outsourcing agreements as a risk management measure in that they provide incentive for the ESP to deliver services at the contracted levels. The service charges paid by agencies are in consideration for performance of the services by the ESP. In general, the higher the level of service the ESP has contractually committed to provide, the higher will be the contracted price for those services.

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[213] The Cluster 3 and Group 5 Agreements provide that, if the ESP fails to meet a service level, the Group or Cluster may require the ESP to pay a service credit in respect of that service level. The ATO Agreement provides that, if the ESP fails to meet a service level, the ESP must pay a service credit to the ATO unless the ATO in its sole discretion agrees otherwise. Schedule 3 of the ATO Agreement states that *Service credits as indicated shall be payable by the ESP to the ATO in the event that the ESP fails to meet the service levels.* This provision appears to make the service credits accrued by the ESP more in the nature of a debt to the ATO as and from the time they are accrued than is the case under the other two Agreements. This increases the need for a clear and transparent accountability framework for their management.

[214] However, agencies need to be aware of what actions or delays on their part may give rise to an estoppel arising which may prevent them from subsequently recovering service credits accrued by the ESP.

Accordingly, should the ESP provide a lower level of service than is provided for under the Agreement, service credits provide a mechanism for agencies to pay a reduced charge. In this way, the service credits act as an incentive to the ESP to provide services to the contracted levels in order to receive full payment.

9.16 The overarching principle agencies must consider in determining whether to apply the service credit provisions available under an outsourcing agreement arises out of section 44 of the *Financial Management and Accountability Act 1997* (FMA Act). Section 44 requires that agency Chief Executives and their delegates manage the affairs of the agency in a way that promotes proper use of the Commonwealth resources. In considering whether to require the ESP to pay service credits available to them under the contract, agencies need to consider which of the available options will make the most effective, efficient and ethical use of resources.[215]

9.17 Deciding whether to impose contractually-available, but discretionary, service credits represents a value-for-money consideration on the part of agencies. The potentially material nature of the service credits that may arise under outsourcing Agreements requires a sound corporate governance framework to support accountability and transparency in forming that determination. Accordingly, decision-making should be conducted in the context of relevant Commonwealth resource-management policy, supported by appropriate legal and practical risk analyses.

9.18 This requirement becomes more complex where multiple agencies are grouped under a single outsourcing agreement. Although the obligations arising under the FMA Act apply to agencies individually, the management of those agreements typically involves a collective approach. In Cluster 3, the decision as to whether to impose service credits accrued by the ESP is a collective decision undertaken by the Cluster 3 MC. In Group 5, although discussed by the Management Committee, each agency has retained the discretion to make an individual determination.

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215 Agencies also need to be aware of what actions on their part may result in the creation of a debt on the part of the ESP. Once a debt is created, agencies must act in accordance with the requirements of the FMA Act in regard to the collection and waiver of debts (s 34). For a service credit to be a debt it must be: (i) a sum of money which is or will be payable by reason of a present legal obligation; (ii) a right which is enforceable by legal action; (iii) certain, or able to be ascertained; and (iv) the subject of a demand for payment.

9.19 At the time of audit, all service credits accrued by the Group 5 and ATO ESPs in accordance with the respective Agreements had been imposed by the relevant agencies. The ATO has also reserved the right to impose further service credits, where appropriate, once the ESP provides it with the necessary supporting information to enable full substantiation of the ESP's reported performance. The operation of the Cluster 3 Agreement has proven complex, and the approach taken to the issue of service credits has evolved over the course of the initial two years.

Cluster 3 experience

9.20 In October 1999, the Cluster 3 MC advised ANAO that the service credit regime contained in the Cluster 3 Agreement has the primary intent of acting as an incentive mechanism for the delivery of services at the contracted levels. The Cluster advised that it views service credits as reduced payment for reduced service delivery—that is, not paying for service not delivered. Upon commencement of the Agreement, the Cluster 3 MC elected to provide the ESP with an initial three month grace period during which it would not be liable to pay service credits.[216] An important component of this moratorium was to provide the ESP time to establish performance measurement and reporting systems suitable for the Cluster 3 context.

9.21 Although a total moratorium on service credits was not specifically contemplated in the Agreement, the Cluster 3 MC advised ANAO that it was a recognition by both parties of the complexity of the Cluster, and of the need to operate through interim arrangements and the initiation of a number of major projects before steady state could be achieved.[217]

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[216] The Cluster 3 MC advised ANAO that the moratorium period was established in the context of a long term deal, and that the Cluster wanted to establish a relationship that worked to its benefit for the term of the contract, rather than adopting a short term view of what financial penalties could be enforced in the first three months. The Cluster 3 MC also advised that it accepts that there was no formal contract change to reflect the arrangement entered into for this period, but that it was aware of the contractual implications arising from its decision to implement a moratorium. In August 2000, the Cluster 3 ESP advised ANAO that: *'The original discussions on the moratorium on Service Credits were well documented between the parties and* [it] *does not believe that there was any need for, nor any value in, a formal variation to the Agreement. In all such contracts there are many changes continually made to suit operating needs and it is totally unrealistic to constantly modify a document, which should be the basis for a living, working relationship.'*

[217] The Agreement provided for a grace period to be allowed on individual service levels for which the ESP was able to establish, prior to handover, that Cluster agencies had not previously been achieving identified minimum performance levels. In April 2000, OASITO advised ANAO that the intent behind the contractual provision was to provide an element of flexibility in how service levels were handled, but that it was negotiated in its existing form to maintain pressure on the ESP. It also noted that, for the service levels in question, there was no existing performance reporting within agencies, and that it proved impractical to implement the necessary tools and procedures to measure agency performance prior to handover. OASITO advised that, with the benefit of hindsight, it was therefore clear that the spirit of the provision could not be implemented strictly within the letter of the contract.

This rationale was not fully documented in Cluster 3 records at the time, and a formal decision by the Cluster 3 MC in respect of the grace period was not recorded.[218] ANAO considers that, in view of the potentially material nature of service credits during this period, and the contractual interpretation necessarily applied in support of the decision to allow the grace period, a more formalised approach to documenting the moratorium arrangement would have been appropriate.

9.22 Similarly, ANAO considers that transparency in public administration would have been assisted by the Cluster agencies more fully documenting their subsequent consideration of service credit-related issues. The calculation of service credits in line with the Agreement commenced in October 1998, with the ESP accumulating significant levels of credits each month for failure to achieve contracted service levels. However, the extent to which the ESP would be required to pay the service credits accrued was the subject of extended discussions between it and the Cluster, with the ESP requesting an extension of the service credit moratorium.

9.23 Discussions on the imposition of service credits related to concerns expressed by the ESP about the impact of 'extraordinary' events, such as the 1998 Federal election and an accelerated rollout of the DIMA desktop upgrade, on its capacity to achieve contracted service levels; and Cluster agencies' concern at the end of 1998 about the ESP's lack of progress in achieving Y2K compliance across the infrastructure (in conjunction with '*the uncertainty of the contract as to the definition of Y2K compliancy, together with the lack of any realistic sanctions for non-performance*'*).* Pending resolution of these discussions, service credits accrued by the ESP were held in abeyance or 'banked'.

218 Documentation in support of the grace period sighted by ANAO consisted of documents prepared by the ESP prior to handover identifying its analysis of existing performance measurement and achievement within agencies; and its planned timeframe for measuring its performance against service levels, and for achieving the contracted levels of service. The documents were signed off by each agency, with the exception of DOFA which did not sign agreement to the document. The document relating to DIMA was signed after the commencement date. Two agencies signed the document with an annotation stating that current levels of performance were at or above contracted levels. The Cluster 3 MC advised ANAO that the subsequent implementation of the grace period without dispute gives rise to a view that the documentation did service the purpose it was developed for, albeit '*without crossing every 't' and dotting every 'i''.*

Revised service credit regime

9.24 Following a series of negotiations, the Cluster 3 MC advised the ESP in March 1999 of a revised service level/service credit regime to apply from October 1998 until June 1999, the end of the first year of the Agreement. The Cluster 3 MC obtained informal legal advice prior to entering into the arrangement. The main elements of the regime were that, in each month between February and June 1999, the ESP could 'earn back' 20 percent of the banked service credits accrued between October 1998 and January 1999, and avoid additional credits, to the extent it achieved minimum specified requirements.

9.25 The revised arrangement introduced a linkage between the application, or otherwise, of service credits and satisfaction of the ESP's contractual obligations in respect to Y2K compliance. Another key aspect of the revised regime was agreement by the Cluster to reduced minimum service levels for specified business-critical services compared to those originally required, with a graduated move back to contracted service levels by June 1999. This arrangement, combined with a requirement to achieve only 95 percent of remaining service levels, significantly reduced the ESP's exposure to service credits in respect of its performance in February to June 1999.[219] In addition, the service credits accumulated up to January 1999 were reduced by 15 percent in recognition of extenuating circumstances.[220]

9.26 The intent of the arrangement was to provide the ESP with incentive to achieve contracted service levels, while giving due consideration to 'extenuating circumstances' identified by it. It was also intended to create an enhanced incentive for the ESP to fulfill its Y2K obligations. However, the value-for-money determination by Cluster agencies in support of that strategy was not fully documented. The Cluster 3 MC advised the ESP that it believed some concession was warranted as a consequence of the extenuating circumstances outlined by the ESP, but agencies' analysis of how those circumstances had

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[219] In advising the ESP of the arrangement, the Cluster 3 MC noted that it believed that, in reaching its decision, it had had regard to the extenuating circumstances highlighted by the ESP, and had accepted some performance shortfalls without imposing service credits. The Cluster 3 MC saw the regime as one which provided incentive to the ESP to reach the required service levels in the nominated timeframe.

[220] The ESP had proposed a discount of 40 percent in recognition of the impact of events such as the October 1998 Federal election, an accelerated desktop rollout in DIMA, and the complexity of the Cluster. The Cluster 3 MC rejected that proposal, but decided that a reduction of 15 percent would be applied to the banked service credits. The Cluster 3 MC indicated that the discount was granted in recognition of the Cluster complexity and the impact on the ESP's service capacity from the election and other major programs initiated by agencies. However, the analysis conducted to identify the appropriate quantum of such a discount was not documented.

impacted on the service provision capacity of the ESP in the areas of concern was not documented. Nor was there documented analysis of the rationale for the 15 percent discount provided on service credits accrued to January 1999, and the interaction of the basis for that discount with the basis for the concessions provided in subsequent months. Enhanced documentation of these aspects would have improved the clarity and transparency of the basis for Cluster agencies' agreement to the arrangement.[221]

9.27 The Strategic Adviser to the IT Initiative had advised the Cluster 3 CMO that it is relatively common for customers in private sector contracts to forego service credits if the outsourcer demonstrates genuine management focus on service problems. Accordingly, the Strategic Adviser recommended that the ESP should be required to propose a plan to rectify service problems; that the Cluster should form a view regarding the plan's credibility for achieving adequate improvement within an acceptable time frame; and that agreement by the Cluster to postpone, and possibly forego, the collection of service credits should be dependent upon the ESP demonstrating satisfactory progress against the remediation plan while not compromising service quality in other areas.

9.28 The ESP was not required to develop and report against an agreed remediation plan as a condition of the Cluster agreeing to the revised regime. Analysis by the Cluster of the credibility of remediation measures proposed by the ESP in other forums was not documented in support of the revised service credit regime.[222] The Cluster 3 MC advised ANAO that, during the period of the revised regime, regular updates on Y2K status were required, and the monthly executive reports provided by the ESP identified the extent to which the ESP was meeting mandatory and other service levels.[223] ANAO considers that, where agencies enter

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221 In August 2000, the Cluster 3 ESP advised ANAO that: '[It] *has paid, and continues to pay, Service Credits demanded by Cluster 3. The circumstances in which Service Credits are calculated and demanded are comprehensively documented on both sides.'*

222 The ESP had provided the Cluster 3 MC with a briefing paper in November 1998 which acknowledged that its service performance still needed considerable improvement to meet agency expectations and business needs. The paper stated that, to systematically and completely address current service performance issues, the ESP had in place a 90-day service improvement plan effective 1 November 1998, which the ESP expected would result in noticeable and continual improvement in all facets of its service culminating in the achievement of contracted service levels by the end of January 1999. The Cluster 3 CMO advised ANAO that the document was an internal ESP document and, although the CMO was briefed on progress against the plan during November and December 1998, it was not linked to service credits or to the revised service credit regime agreed in March 1999.

223 In August 2000, the Cluster 3 ESP advised ANAO that: *'Throughout the operation of the Agreement,* [it] *has provided—and continues to provide—Cluster 3 with its plans for improvement and is in continuous discussion about those plans and about reporting requirements.*

into similar arrangements regarding the application of services credits, it would be of benefit to include an agreed remediation plan and associated milestones as part of the formal arrangement with the ESP. This will enhance the capacity of agencies to appropriately monitor and report on the achievement by the ESP of the expected improvements as a basis for establishing the value-for-money obtained from foregoing some or all of the contractually-available service credits, and the relative costs and benefits of continuing with such an arrangement.

9.29 The ESP did not satisfy the minimum performance criteria established under the revised arrangement in any of the relevant months to June 1999. The smaller agencies in the Cluster were still expressing strong dissatisfaction with the performance of the ESP in June and July 1999. By the end of 1999, the Cluster had imposed all service credits available under the revised regime, being \$2.4 million in respect of services delivered in 1998-99.[224] Due to the effect of the revised regime agreed to by the Cluster, this was \$1.3 million or 35 percent less than the quantum of resources available to the Commonwealth under the contracted service level/service credit model (excluding the effect of the initial moratorium). A lower minimum level of service for business-critical services than that required under the original contract was also agreed for a period of time.[225]

9.30 In commenting on the proposed audit report, the Cluster 3 ESP advised ANAO that:

> [It] *is committed to the principle of Service Credits as incentives for continuous improvement. However, the Service Levels in the Cluster 3 Agreement were written in a vacuum, prior to either Government or* [itself] *having real experience of how these would operate in practice. In* [its] *view, they had the opposite effect from Government's intention that they should provide an incentive for better performance. Had they* ***not*** *been reviewed to a more realistic approach, the consequences upon the long-term operation of the Agreement would have been significantly detrimental to Government and certainly would have been out of line with the 'Best Practice' approach espoused.*

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224 AEC and DIMA have elected to take at least part of these service credits in the form of additional project work.

225 In November 1999, the Cluster 3 MC received legal advice which stated that the March 1999 letter from the Cluster to the ESP setting out the revised service credit arrangement represented: '*a notification to the ESP of the fact that the Cluster intends to waive its right to insist on performance of specified services in accordance with the contract, and instead the Cluster will accept performance of the services at lower levels for a defined period (ie February to June 1999).*'

9.31 ANAO recognises the complex problems encountered by Cluster 3, and the need to give due consideration to the imposition of service credits in the light of the overall outcomes desired from the relationship with the ESP. The Cluster 3 MC advised ANAO that it is its very strong contention that the banked arrangements for service credits '*contributed materially to the energetic focus by the ESP in achieving Y2K compliance during the remainder of* [1998-99]', and that its success in focusing the ESP on achieving its Y2K contractual obligation within necessary timeframes was indicative of the value of the negotiated position reached.[226] Nevertheless, the materiality of the service credits involved has implications for financial management.

9.32 In February 2000, the Cluster 3 MC advised ANAO that the service levels in the Cluster 3 Agreement were a specification of the levels judged to be required by agency business needs and widely recognisable as 'industry achievable', with marketplace responses sought to meet that specification. The Cluster 3 MC noted that subsequent independent assessment had confirmed that the service levels set out in the Agreement were, with a number of anomalies, well aligned with industry standards. In these circumstances, ANAO considers that enhanced documentation of the value-for-money analysis undertaken by Cluster agencies as the basis for agreeing to the initial service credit moratorium and subsequent service level/service credit arrangement, and of the Clusters' monitoring of achievement of that value-for-money, would have improved the transparency of decision-making on this matter.[227] In particular, it would

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[226] The Cluster 3 MC advised ANAO that: '*this was an area of grave concern to the Cluster and it is arguable whether the Cluster would have focussed the ESP's attention on Y2K without the added incentive provided for by the banked arrangements'.*

[227] This is particularly the case in light of the acknowledgment by the ESP in the Cluster 3 Agreement to the effect that: '*its commitment to achieve the service levels set out in the Agreement, and its commitment to substantial service credits if those service levels are not achieved, were important considerations in* [its] *selection as the supplier of IT&T services.'*.

have improved the transparency of agencies' assessments that adoption of the revised regime represented the most efficient, effective and ethical use of the available resources in accordance with s44 of the FMA Act.[228] As noted in Chapter 8, there has been improvement in the level of service delivered by the ESP since that time.

Framework for applying service credits

9.33 Given the discretionary nature of the service credit provisions, it is important that agencies implement a robust framework that ensures transparency in the application of that flexibility. The Cluster 3 MC advised ANAO that it accepts the proposition that the use of discretionary provisions in contracts over the application of service credits would benefit from greater administrative policy guidance. The situation faced by Cluster 3 is indicative of the issues likely to increasingly face agencies in the management of outsourced arrangements. The early development of a strategy for the consideration of potential trade-offs involving available service credits could provide agencies with a sound basis to protect the Commonwealth's interest in negotiations involving issues of ESP non-performance. In particular, such a strategy should provide for transparency of the analysis supporting the determination that a particular option represents the best value-for-money. Some of the legal issues that need to be considered are outlined in Figure 9.1. Agencies' consideration of such issues must also have regard for the obligations arising under s44 of the FMA Act. It would also be prudent for agencies to ensure they obtain formal specialist advice regarding negotiations undertaken or elections made.

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[228] In November 1999, the Cluster 3 MC received legal advice which stated that: '*Commonwealth officers are not relieved of their duties under s44 simply because the mode of collection of Service Credits does not give rise to a debt. The right to deduct service credits against future contractor invoices, or to obtain a credit note for goods and services, is a valuable resource. Section 44 FMA Act, in our view, imposes a duty on Commonwealth officers to make available the relevant deductions, or pursue the available credit notes, if this course represents the most efficient, effective and ethical use of Commonwealth resources, for which they are responsible. In light of this obligation, where future contractor invoices are available against which to exercise deductions, or where a credit note is able to be obtained (ie the contractor is still trading), there would appear to be little scope for a Commonwealth officer to 'waive' or otherwise avoid collection of service credits. However, there may be circumstances in which an agency could justify non-deduction or non-collection of service credits, if it could show that the Commonwealth had or would receive value for the relevant service credits in some other and equivalent way*.' The revised arrangement agreed to by the Cluster 3 MC was premised on the incentive provided to the ESP by the potential for it to earn back accrued service credits (that is, for the service credits to be effectively foregone or 'waived'), and for further service credits to not arise until the level of service provided was at a significantly lower level than that provided for in the Agreement (that is, a proportion of service credits provided for under the Agreement were to be foregone or 'waived'). The legal advice provided to the Cluster 3 MC highlights the need for agencies to adequately document the value-for-money assessment undertaken as the basis for decisions made regarding the exercise of discretionary service credit provisions.

Figure 9.1

Possible issues to be considered in applying service credits

Issues
• Agencies need to consider a range of issues concerning any ESP non-performance including: – the nature of the non-performance; – how long the non-performance has been continuing; – the seriousness of the non-performance for the overall contract; – whether the particular non-performance has occurred before; – whether the non-performance is in breach of the contract; and – how quickly the non-performance can be corrected.
Risk analysis
• If the non-performance is significant, but not sufficient to require termination of the contract, is the ESP willing to correct the non-performance? – If yes, is there a risk that allowing the ESP time to correct the non-performance will defeat the purpose of the contract, or lead to potential liability for the Commonwealth eg. to third parties? – If no, is there a risk that the right to impose service credits may be lost as a result of delay or failure to exercise that right? • If the risk associated with allowing the ESP time to correct the non-performance is high, or it is unwilling to correct the non-performance (either at all or within a reasonable time period), will the imposition of service credits genuinely threaten its capacity to continue performance of the contract? – If yes, are there any contractual provisions for an alternative ESP to take over the contract, and are there any alternatives to the imposition of service credits available under the contract eg. deduction of security deposits? – If no, what is the potential loss to the Commonwealth should the ESP be unable to continue its performance of the contract? If the loss is significant (within the context of the contract), what are the risks associated with application of service credits on an escalating or deferred basis, or in a reduced amount? • Have there been any words or conduct by the Commonwealth which may give rise to a waiver of the right to impose service credits by election or estoppel? – If no, is there a risk that there will be no future invoices against which the Commonwealth may be able to impose rebates or no future or other contracts against which the Commonwealth may issue a credit note?

Source: Advice from Australian Government Solicitor and ANAO analysis

9.34 **Finding:** The Cluster 3, ATO and Group 5 Agreements provide the relevant agencies with a discretion as to whether to impose service credits accrued as a result of the ESPs' contractual non-performance. The approach adopted to the application of service credits in Cluster 3 has differed from that taken by the ATO and Group 5, both of which have applied service credits as they were accrued by the respective ESP in accordance with the Agreements.

9.35 The Cluster 3 Management Committee (Cluster 3 MC) elected to provide the ESP with an initial three month grace period during which it would not be liable to pay service credits. ANAO considers that, in view of the potentially material nature of service credits during this period, and the contractual interpretation necessarily applied in support of the decision to allow the grace period, a more formalised approach to documenting the moratorium arrangement would have been appropriate.

9.36 The Cluster 3 MC subsequently agreed to a revised service credit regime that significantly reduced the ESP's exposure to service credits in respect of its performance in 1998-99. The intent of the arrangement was to provide the ESP with incentive to achieve contracted service levels and its Y2K obligations, while giving due consideration to 'extenuating circumstances' identified by the ESP. Due to the effect of the arrangement, at least $1.3 million in service credits representing resources contractually-available to the Commonwealth were not imposed in respect of service failures by the Cluster 3 ESP in 1998-99, and a lower minimum level of service for business-critical services than that required under the original contract was agreed for a period of time. Enhanced documentation of the value-for-money analysis undertaken by Cluster agencies as the basis for agreeing to the initial service credit moratorium and subsequent service credit arrangement, and of the Clusters' monitoring of achievement of that value-for-money, would have improved the transparency of decision-making on this matter. In particular, it would have improved the transparency of agencies' assessments that adoption of the revised regime represented the most efficient, effective and ethical use of the available resources in accordance with s44 of the FMA Act.

9.37 The early development of a strategy for the consideration of potential trade-offs involving available service credits could provide agencies with a sound basis to protect the Commonwealth's interest in negotiations involving issues of ESP non-performance. In particular, such a strategy should provide for transparency of the analysis supporting the determination that a particular option represents the best value-for-money.

Recommendation No. 17

9.38 ANAO *recommends* that, in managing IT outsourcing agreements, relevant agencies develop procedures for the conduct and documentation of the processes followed in evaluating options for the use of contractually-available service credits to facilitate effective delivery by the external service provider of contracted services.

9.39 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response:*** **Agree with qualification.** Agencies will continue to pursue a flexible, outcomes-oriented approach for the exercise of service credits and other contractual mechanisms, with an emphasis on encouraging good contractor performance. It should be acknowledged that agencies may responsibly take decisions to redirect or reprioritise contractor resources to address the business needs of the agencies.

Cluster 3 service level review

9.40 Final determination by Cluster 3 on the imposition of service credits accrued in 1998-99 was delayed until December 1999 due to a further round of extended discussions with the ESP regarding the appropriateness and/or effectiveness of the contracted service level/ service credit regime.[229] The effectiveness of service levels and service credits as a management tool in an IT outsourcing arrangement is dependent upon the extent to which they unambiguously focus the management effort of both the ESP and agencies on the aspects of service delivery most relevant to agencies' business requirements, and provide appropriate incentives to the ESP to deliver the contracted services in a manner that best supports those requirements.

9.41 Although establishing effective service levels at the time of outsourcing is important, their periodic review is also important to ensure they remain relevant to agencies' business requirements. International experience has highlighted this, with many organisations seeking to renegotiate long term agreements early in the life of the relationship because they found the existing agreement did not adequately reflect their true business and operational requirements. Each of the Cluster 3, ATO and Group 5 Agreements require that the service levels be periodically reviewed.

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229 In June 1999, the ESP had claimed that it was achieving 90 to 95 percent of service levels and considered it to be unrealistic to achieve 100 percent. The ESP expressed the view that the existing service level/service credit regime was punitive, did not recognise improvements made by it and was damaging to the relationship. The Cluster 3 MC advised ANAO that the delay in proceeding with the arrangement was to ensure that the Cluster gave credible consideration to concerns raised by the ESP that the service credits were 'unreasonable and unconscionable'. The Cluster's legal adviser advised a meeting of the Cluster 3 MC in July 1999 that, in their view, the service credit framework was not punitive.

9.42 Cluster 3 had observed anomalies in the operation of the service credit provisions. These included the large number of service levels reported against (over 600); difficulty in aligning service credits with business impact, including the potential for extremely high service credits for little or no Cluster business impact[230] and extremely low service credits applying to quite major outages[231]; a service credit model that encouraged performance only until it was evident that performance against a particular service level could not be met in the reporting period[232]; and some services important to agencies not covered by existing service levels.[233] The need to review the validity, currency, management value and measurability of the Cluster 3 service level/service credit regime was supported by an independent consultant engaged by the Cluster 3 CMO in June 1999.[234]

9.43 In August 2000, the Cluster 3 ESP advised ANAO that:

> *In reality, the number of Service Level Agreements was excessive and some were extremely difficult and, indeed, costly to both sides to attempt to measure. More importantly, their structure was insufficiently related to the business impact upon agencies and the associated Service Credits disproportionately allocated. These factors are significant to* [us] *and to the various organisations involved in Service Delivery, to which* [we] *are committed under* [the Cluster 3] *Industry Development Plan.*

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230 The Cluster observed that this can have the effect of shifting the ESP's focus to an area that may be at odds with what the Cluster sees as important, with the risk of the ESP's resources not being focussed on critical performance areas not as well covered by service levels.

231 For example, the outage of a DIMA server in March 1999 resulted in hundreds of users being without their file server for over a day, but carried a direct service credit of only $640.

232 Under the service credit model in the Cluster 3 Agreement, a service failure early in a month would quickly expose the ESP to the maximum applicable service credit. As a result, there was no further incentive for the remainder of the month to recover and continue to provide quality service. Best practice advice in this area is for service credits to escalate in some form with continued non-performance, and for the percentage amount of service credit to be structured so as to increase for each month that the same service level is missed. These strategies assist in providing incentives for the ESP to address performance issues in a timely manner.

233 These included services relating to problem notification and reporting, virus protection, preventative maintenance, procurement and midrange services for DIMA, including to overseas posts.

234 The consultant's report noted that, in general, the existing service levels did not appear overly aggressive when compared to industry experience, but a number appeared questionable as to their validity and direct impact on agencies and, consequently, could become unnecessary cost drivers, while others should be tightened.

9.44 In August 1999, the Cluster formed a joint working party with the ESP to review the service level and service credit provisions of the Cluster 3 Agreement. That review, finalised in April 2000[235], resulted in the development of new service level and service credit models for all agencies. The new models are expected to provide a better service delivery outcome for the agencies, while addressing the ESP's concerns over service level anomalies in the existing Agreement. The number of service levels was reduced by over two thirds, and all now have an associated service credit model that ramps up the credits payable in line with how badly a service level is missed.[236] The revised models will apply from January 2000, pending validation and final negotiation. The work undertaken by Cluster 3 in this area would be of value in assisting other agencies in both the formation and management of service levels and service credits under an IT outsourcing arrangement.

9.45 In August 2000, the Cluster 3 ESP advised ANAO that:

> *Cluster 3 Agencies and* [itself] *have jointly reviewed Service Level Agreements in order to make them more realistic, more measurable and more directly related to agency business outcomes. In those professional, objective and thoroughly documented discussions, necessary changes were made and a number of Service Levels were introduced into areas where the Agreement had not previously specified them. The outcome is achieving Government's objectives for SLAs. In the Service Level discussions, both* [ourselves] *and* [the] *Cluster undertook substantial research and external benchmarking to ensure that the outcomes were realistic and maintained the value-for-money objective of Government.*

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236 The review took considerably longer than anticipated, primarily due to the magnitude of the exercise. It was noted that a considerable amount of consultation and analysis had gone into the development of the revised models; arguably, much more than went into the development of the original RFT models.

236 Under the revised model the ESP's exposure to service credits each month is capped at 15 percent of revenue from each line of service, compared to the previous overall cap of 25 percent. This arrangement has some similarities with that included in the Group 5 Agreement, under which the Group attempted to ensure there was appropriate incentive for the ESP to focus on service delivery to all agencies.

9.46 **Finding:** The effectiveness of service levels and service credits as a management tool in an IT outsourcing arrangement is dependent upon the extent to which they unambiguously focus the management effort of both the ESP and agencies on the aspects of service delivery most relevant to agencies' business requirements, and provide appropriate incentives to the ESP to deliver the contracted services in a manner that best supports those requirements. In August 1999, Cluster 3 formed a joint working party with the ESP to review the service level and service credit provisions of the Cluster 3 Agreement. The review resulted in the development of new service level and service credit models that are expected to provide a better service delivery outcome for the agencies, while addressing the ESP's concerns over service level anomalies in the existing Agreement. The work undertaken by Cluster 3 in this area would be of value in assisting other agencies in both the formation and management of service levels and service credits under an IT outsourcing arrangement.

Data security

9.47 Data security considerations are important in any IT outsourcing process, particularly with security requirements and sound security practices evolving at a rapid pace as technology changes.[237] However, these issues can become magnified in an environment in which a number of agencies are 'clustered' or grouped. Unless agencies of similar requirements have been grouped, the security requirements of one agency can have an effect upon the cost-effective provision of IT services to other agencies within the group. Alternatively, the security environment of one agency can represent a security risk to others in the group. This is particularly the case where the solution proposed by the ESP relies upon consolidation to achieve efficiencies.

Preparatory steps

9.48 Commonwealth agencies are required to protect all official Commonwealth Government information from unauthorised access, disclosure, modification, manipulation or destruction.[238] That obligation remains with the agencies regardless of whether the IT infrastructure

[237] IT security concerns relate primarily to the principles of integrity, confidentiality and availability. This includes preventing unauthorised access to agency information systems, storage media and the data contained on them; detecting any such access that does occur; and preventing damage or loss of data through unauthorised access or transmission of computer virus. The level of protection required will depend upon the nature of the data stored on and passed through a particular information system.

[238] Protective Security Manual, Section 6.3.

has been outsourced. In August 1997, the *IT Infrastructure Security Framework for Outsourcing* (the DSD framework) was jointly released by the Defence Signals Directorate (DSD), the Attorney-General's Department and OGIT. The purpose of the document was to assist agencies in determining what their security regime should be in an environment in which the management and operation of their IT systems and services may be outsourced.

9.49 The DSD framework emphasised the need for each agency to have its information security objectives, plans and processes in place <u>before</u> the management and operation of its IT was contracted out so that the desired security levels could be maintained. It identified a number of tasks that agencies must conduct in order to be able to establish an effective security framework in an outsourced environment.[239] The DSD framework also recognised that the clustering of agencies for the outsourcing of IT assets had additional ramifications for information security. Other preparations recommended for dealing with this aspect of outsourcing were ensuring that:

- agencies being grouped had similar confidentiality, integrity and availability requirements, as outlined in their individual information systems security policy; and
- that a concept of operations detailing the mechanisms for achieving the segregation and need-to-know security of the individual agencies' information within an outsourced IT cluster was developed and had been approved by each agency.

9.50 Submissions supporting the IT Initiative proposed that, in order to achieve a set of consistent IT security specifications, agencies map key elements of their existing IT Security Plans to a common IT security framework. It was also recognised that agency security frameworks should be able to contribute to common security requirements for the cluster, form the basis for negotiating security requirements with tenderers and provide a benchmark for continuous assessment of compliance with contractual obligations.

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[239] These included: having a documented set of security objectives, in terms of confidentiality, integrity and availability (the Information Systems Security Policy (ISSP)); conducting a Threat and Risk Assessment (TRA) for the agency's information assets in order to identify those most in need of protection and enable prioritisation of security mechanisms; developing System Security Plans to outline the mechanisms required to secure each individual information systems to meet the security objectives in the ISSP and address the risks identified in the TRA; establishing an IT Steering Committee to review proposed changes to the IT environment and determine whether these are detrimental to the security of the agency's information assets; and having a designated IT Security Manager responsible for managing the security aspects of the storage and processing of its information.

9.51 ANAO identified differing approaches between agencies in respect of these preparatory issues. Some agencies, such as the NCA, PM&C and ATO, placed particular emphasis on this aspect of their preparation and planning for participation in the IT Initiative. However, other agencies appeared to have been less proactive, with scope for improvement in the extent, and timing, of attention to the recommended preparatory steps in the Cluster 3 and Group 5 tenders.

Contractual requirements

9.52 The principle mechanisms through which an agency is able to control or direct ESPs' actions in regard to security concerns is through the requirements set out in the Agreement, and its actions in managing compliance with those requirements. The formalisation of security requirements for inclusion in outsourcing Agreement can, in some cases, represent an improvement over the internal security arrangements previously existing within agencies.[240]

9.53 The Cluster 3 Agreement sets out a number of requirements for the external accreditation by Commonwealth security agencies of the IT systems and facilities used by the ESP to deliver the services. The ESP was required to obtain accreditation for physical and logical security by the commencement date, Internet Gateway security by September 1998, and there was an ongoing requirement to ensure ESP personnel had the appropriate security clearances.

9.54 Although a number of these requirements have been satisfied, there has been significant delay in the ESP obtaining the required security certification of the Cluster 3 network by DSD.[241] The Secure Internet Gateway (SIG) was given an interim accreditation by DSD in December 1998, but there continued to be significant delays in progressing full accreditation of the SIG and the Cluster network. In September 1999, the Cluster 3 CMO advised the Cluster 3 MC that delays in achieving accreditation represented a major exposure for the ESP and the Cluster, and re-iterated to the ESP that there was a need for a heightened focus on achieving security accreditation. As at August 2000, full DSD security certification of the Cluster 3 network had not yet been obtained in line with the contractual requirements.

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240 For example, the requirement to protect all classified official information means that agencies should encrypt external communication links. Prior to the Group 5 outsourcing process, some Group agencies did not comply with that requirement.

241 The cost of the certification ($10,000 with an annual charge of $6,000) is borne by the Cluster.

9.55 A factor in the extensive delay in obtaining the required certification appears to have been an inadequate appreciation at the time of executing the 1998 Agreement of the resource commitment entailed by both parties in obtaining the level of sign-off being sought. There also appears to have been a lack of clarity or shared understanding of the nature of the contractual commitment made, and how it would be satisfied. For example, in September 1999, some fifteen months after the commencement of the Agreement, the Cluster 3 CMO advised the Cluster 3 MC that it was still not clear from discussion with the ESP and DSD what was a realistic timeframe to achieve accreditation status. It was noted that this uncertainty related partly to the fact that this was the first Government outsourcing initiative to be subject to DSD accreditation requirements.

9.56 In May 2000, the Cluster 3 MC advised ANAO that, although there had been a delay in achieving full security certification, over 95 percent of the task had been completed and it was of the view that the Cluster 3 environment was nevertheless a secure environment. The Cluster 3 MC also noted that a model for reviewing security requirements for a collaborative environment such as Cluster 3 had had to be developed as it had not previously existed. The Cluster 3 MC advised ANAO that it was confident that final certification would be achieved by the end of June 2000. As noted, as at the end of August 2000, final certification had not yet been achieved.

9.57 In commenting on the proposed audit report, the Cluster 3 ESP advised ANAO that:

> [It] *has taken considerable pains from the inception of the Agreement to ensure that its clients' data is protected and believes there has never been any measurable risk of any significance to the Commonwealth. The overall level of security is, without question, greater than it was under any individual agency. This has been achieved at considerable cost to* [us].
>
> *Accreditation by the Defence Signals Directorate is not a simple, quick or precise process. It is **not** a matter of meeting a set of previously prescribed parameters and standards. **These do not exist**, rather the process is an iterative one involving DSD's response to proposals put to it by* [us].

9.58 In considering a September 1999 CMO paper proposing an audit program for the Agreement, the Cluster 3 MC considered that an audit of the ESP's security activities against the provisions of the contract should be accorded highest priority. As at June 2000, the Cluster had not yet commenced security inspection activities pending finalisation of the DSD certification. The Cluster 3 CMO advised ANAO that, as part of that process, DSD would approve a Security Management Plan incorporating details of audits and inspections that would be carried out on the ESP's infrastructure.[242]

9.59 The ATO and Group 5 Agreements set out a framework of security obligations on the ESP and provide for the audit and inspection of compliance with those obligations, but do not include a specific contractual obligation for the ESP to obtain external security certification of its systems.[243] It is, however, open to the agencies to seek such certification. For example, in Group 5, PM&C has required the ESP to satisfy Commonwealth security agency requirements in relation to its remote management network before it will allow the ESP to connect it to the network.[244] The ATO and Group 5 Agreements do not identify which party is responsible for the costs associated with obtaining external security certifications or assessments where agencies consider this appropriate.[245]

Identifying security certification requirements

9.60 Identifying the security requirements that should appropriately be included in an IT outsourcing agreement, and the extent of independent certification required, should entail an informed analysis

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242 In September 1999, the Cluster 3 CMO advised ANAO that one Cluster agency, DIMA, had initiated an internal audit of its Access Control policies and procedures for mainframe, midrange and LAN systems.

243 Each Agreement does require that ESP personnel obtain appropriate Commonwealth security clearances. The ATO Agreement requires that the encryption facility on telecommunications networks be certified by DSD, and requires that all processing and information storage sites and facilities established and/or used by the Contractor (or the Contractor's subcontractors) which are not ATO or Commonwealth sites comply with the requirements of DSD ACSI 33 physical security classification CR1 (Highly Protected). Secure internet gateways implemented by the ESPs' will also require DSD certification.

244 In August 2000, the Group 5 ESP advised ANAO that: 'S*pecific security requirements need to be settled consistently with the solution, in consultation between the ESP, customer and certification authority. In accordance with their operational and procedural requirements, PM&C security requirements were agreed and scoped shortly after transition.'*

245 In May 2000, DSD advised OASITO that a security review may uncover inadequacies that have been in place from well before transition to the ESP, and consequently there may be disagreement about the need or cost for rectification.

of the relevant threats, risks, costs and benefits. Throughout the Cluster 3 tender process, the National Crime Authority (NCA) had expressed concern that the ESP must meet its security requirements, which were of a substantially higher level than those identified by other Cluster agencies. The requirement that the ESP obtain DSD certification of the logical security of the Cluster 3 infrastructure was incorporated into the Agreement in response to NCA's concerns. NCA represented less than 3 percent of Cluster 3 mainframe services, and, due to its security requirements, required a separate mainframe to that used to service the rest of the Cluster. NCA is no longer part of Cluster 3 as it no longer has a mainframe requirement. ANAO identified no analysis having been conducted in the tender process of the costs and benefits of requiring full DSD certification of the infrastructure used to service the rest of the Cluster.

9.61 DSD highlighted this issue to OASITO in May 2000, commenting that it is important that both agencies and ESPs are aware of the cost and resource implications of contractual clauses requiring certification of infrastructure post-outsourcing. DSD noted that, while not suggesting that certification is not necessary, most agencies have not undergone a full infrastructure certification prior to outsourcing and, in many cases, may not realise the implications of a request of this nature. DSD suggested that it could play a useful role in assisting agencies to evaluate the relative costs and benefits of including such requirements in their outsourcing agreements.

9.62 ANAO considers that the effectiveness with which such processes are undertaken in future IT outsourcing tenders could be enhanced by obtaining from tenderers a demonstrated understanding of the security implications of their proposed solution. This could take the form of a draft threat and risk assessment, which would allow agencies to test the due diligence undertaken. Where a requirement for independent security review is identified, it would also be useful to include in the Agreement some form of service level for the management of security standards to provide incentive for the ESP to display a strong commitment to the completion of the review. DSD advised the Cluster 3 CMO that it had been considerably hampered in its efforts to certify Cluster 3 systems by significant delays in the provision of adequate documentation by the ESP.[246]

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[246] Examples included provision of network documentation; a Key Management Plan; inventory of cryptographic equipment; access control policies and procedures; and user awareness programs.

9.63 The experience of Cluster 3 and Group 5 has also demonstrated that, while there are benefits to the aggregation of IT infrastructure across agencies, there are also potential drawbacks in that multiple agencies now have a stake in the issues that affect the security of that shared infrastructure. This has increased the complexity involved in establishing and managing a secure IT environment, highlighting the need for agencies to adopt a structured, strategic approach to this issue early in the tender process.[247]

9.64 DSD has suggested that a useful mechanism would be for agencies to create and maintain an 'Enterprise Security Architecture' document that clearly lays out the agencies' operational security issues and identifies the necessary safeguards, with a follow on security plan then describing the implementation of those safeguards. A security policy of this nature will assist in ensuring any security certification process is better focused from the start of the process.

9.65 In providing comment on the proposed audit report, the Department of Defence advised ANAO that:

> *A conclusion to be drawn from the DSD experience and also from the report, is that given the present state of the industry in Australia, outsourcing the management of high security networks would be a risky and also costly business. External service providers are not experienced in managing networks to national security standards, as commercial risk drivers do not equate readily to government accountability requirements, let alone to managing counterintelligence threats. The identification and then oversight of contractual obligations would therefore be even more resource-intensive than for conventional government networks. Another point to be noted is the view that in the intelligence community, information security is a core management responsibility for which we must be held accountable, rather than a support function that can be offered up for external administration.*

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[247] About three weeks prior to the handover of the Group 5 infrastructure to the ESP, the Group 5 CMO requested DSD conduct an initial review of the ESP's intended solution. The need for such review does not appear to have been considered earlier in the tender process.

9.66 **Finding:** ANAO identified differing approaches between agencies in respect of recommended preparatory steps for the security aspects of outsourcing IT infrastructure. Some agencies, such as the NCA, PM&C and ATO, placed particular emphasis on this aspect of their preparation and planning for participation in the IT Initiative. However, other agencies appeared to have been less proactive, with scope for improvement in the extent, and timing, of attention to the recommended preparatory steps in the Cluster 3 and Group 5 tenders.

9.67 As at August 2000, full security certification of the Cluster 3 network had not yet been obtained in line with the contractual requirements. A factor in the extensive delay in obtaining the required certification appears to have been an inadequate appreciation at the time of executing the 1998 Agreement of the effort and resource commitment entailed by both parties in obtaining the level of sign-off being sought. The ATO and Group 5 Agreements set out a framework of security obligations on the ESP and provide for the audit and inspection of compliance with those obligations, but do not include specific contractual obligations for the ESP to obtain external security certification of its systems. Neither Agreement identifies which party is responsible for the costs associated with obtaining external security certifications or assessments where agencies consider this appropriate.

9.68 Identifying the security requirements that should appropriately be included in an IT outsourcing agreement, and the extent of independent certification required, should entail an informed analysis of the relevant threats, risks, costs and benefits. ANAO considers that the effectiveness with which such processes are undertaken in future IT outsourcing tenders could be enhanced by obtaining from tenderers a demonstrated understanding of the security implications of their proposed solution. Where a requirement for independent security review is identified, it would also be useful to include in the Agreement some form of service level for the management of security standards to provide incentive for the ESP to display a strong commitment to the completion of the review.

9.69 DSD has suggested that a useful mechanism would be for agencies to create and maintain an 'Enterprise Security Architecture' document that clearly lays out the agencies' operational security issues and identifies the necessary safeguards, with a follow on security plan then describing the implementation of those safeguards. A security policy of this nature will assist in ensuring any security certification process is better focused from the start of the process.

Recommendation No. 18

9.70 ANAO *recommends* that, where appropriate in outsourcing IT infrastructure services, agencies develop, in consultation with the Defence Signals Directorate, an integrated security architecture strategy that addresses operational security issues, identifies the necessary security safeguards and the required timetable for their implementation by the external service provider.

9.71 Agencies responded to the recommendation as follows:

- ***Department of Defence*: Agree.** The report is fully consistent with the experience of DSD's Information Security Branch in supporting IT outsourcing initiatives, particularly the Cluster 3 and ATO exercises. DSD intends to work closely with the forthcoming Cluster 1 and Cluster 10 initiatives to apply the lessons, especially Recommendation 18, concerning integrated security architectures. DSD is also intending to establish a scheme whereby commercial IT security consultants can be accredited as being able to interpret and apply government standards—this should be of great value to Commonwealth agencies.
- ***DOFA whole-of-government response:* Agree**. Security requirements have been addressed with the assistance of Defence Signals Directorate in all tender processes conducted under the Initiative having regard to existing security arrangements in the relevant agencies. The development of group security policies is considered on a case by case basis having regard to both existing security arrangements and the contractual framework for each Group.

Privacy

9.72 The *Privacy Act 1988* (Privacy Act) places specific obligations on agencies to protect the privacy of personal information held or collected by them. These requirements are quite distinct from, and must be addressed separately to, other confidentiality and security requirements. When an agency outsources functions that can potentially give ESPs access to information that is subject to the Privacy Act, it must ensure that those obligations are still met. The private sector is not subject to the same statutory privacy obligations as apply in the public sector. The Information Privacy Principles (IPP) set out in the Privacy Act only apply to the acts or practices of agencies. Accordingly, contractual requirements are needed to oblige the ESP to ensure privacy obligations are met.

9.73 The Privacy Commissioner's Guidelines in relation to outsourcing contracts highlight that agencies should take care to see that there are no contradictions or inconsistencies between confidentiality and privacy clauses. The Guidelines note that it is common for confidentiality clauses to aim to protect all information, including personal information, and that requirements under confidentiality clauses may not meet the same standard as is required under those clauses specific to privacy and personal information. It is not clear that the Cluster 3, ATO and Group 5 Agreements appropriately differentiate between, and provide for, the different protection regimes required for confidential information and personal information.

9.74 The Cluster 3, ATO and Group 5 Agreements deal with the protection of personal information under two separate clauses—Confidentiality and Privacy. Each Agreement includes a confidential information protection regime.[248] The Agreements also set out a separate obligation requiring the ESP to comply with the Privacy Act as if it were included in the definition of 'agency' within that Act and, in the case of the ATO, to comply with the privacy provisions in all legislation administered by the ATO. The Privacy Act sets out a very specific regime for the collection, use, access to, destruction, alteration, or addition to personal information. This regime is not recognised or catered for in the confidentiality clause. ANAO considers that it would be of benefit for relevant agencies to ensure that future IT outsourcing Agreements appropriately differentiate between personal information and confidential information, and the protection regimes that must be applied to each class by the ESP.

9.75 The Agreements and related schedules largely reflect the contractual provisions set out in the Privacy Commissioner's Guidelines.[249] The Guidelines recommend that outsourcing Agreements include an acknowledgement by contractors that disclosure of personal information is an offence under the *Crimes Act 1914* (Crimes Act) and other relevant Acts, and that this clause should be reproduced in a privacy deed to be signed by the contractor's employees. The Privacy Commissioner's recommended clause is reflected in the Deed of Confidentiality provided for under each Agreement, but not in the Agreement itself as recommended by the Privacy Commissioner. ANAO considers that the Privacy Commissioner's recommended contractual clauses on the effect of the Crimes Act should also be incorporated in the Services Agreement.

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[248] The definition of 'confidential information' in the Agreements includes 'personal information', yet the protection regimes required for these classes of information are different.

[249] The draft Cluster 3 Agreement was provided to the Privacy Commissioner for comment, but this was not the case with subsequent Agreements.

9.76 The Privacy Commissioner's Guidelines provide that monitoring by agencies of an ESP's compliance with its privacy obligations should be undertaken on a regular basis, as well as on the occurrence of any event which may have significant privacy implications. The Guidelines also note that a failure to ensure a reasonable standard of monitoring may be considered a breach of IPP 4.[250] The Cluster 3, ATO and Group 5 Agreements provide extensive audit access provisions to enable agencies or their internal or external audit representatives (including consultants, the Auditor-General and the Privacy Commissioner) to monitor compliance by the ESP (and its subcontractors) with its privacy obligations. This includes the right to perform audits and inspections of general controls and security practices and procedures, including review of any process that impacts the privacy or security of agencies' data and any of the software, systems and data used to provide the services to the agencies.

9.77 Shortly after the ATO Agreement commenced in June 1999, the ATO Internal Audit Branch commenced audits of the ESP's compliance with its security and privacy requirements, but had yet to complete this important task during the period of audit fieldwork. In commenting on the proposed audit report, the ATO advised ANAO in August 2000 that its Internal Audit Branch had completed its reports into *Privacy, Security and Access*, and that *'the actions to address the issues identified are being implemented.'* In Group 5 and Cluster 3 were yet to undertake audits or reviews of the relevant ESP's compliance with its privacy obligations, or develop a strategy for monitoring that compliance. ANAO considers that, in outsourcing their IT, it would be of benefit to agencies to institute such a strategy, including a process for ensuring that all personnel of the ESP who will have access to the personal information are properly briefed about their obligations in relation to the treatment of that information.[251]

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250 IPP 4 requires agencies to protect personal information against misuse by reasonable security safeguards if outsourcing.

251 The ATO Agreement requires the ESP to provide the ATO with evidence that security awareness training and materials have been provided to its personnel, but there is not a similar requirement for privacy requirements.

9.78 **Finding:** The *Privacy Act 1988* (Privacy Act) places specific obligations on agencies to protect the privacy of personal information held or collected by them. Currently, the private sector is not subject to the same statutory privacy obligations as apply in the public sector. Accordingly, the only mechanism for obliging the ESP to ensure privacy obligations are met is through contractual requirements. The Agreements set out a separate obligation requiring the ESP to comply with the Privacy Act as if it were included in the definition of 'agency' within that Act.

9.79 The Privacy Commissioner's Guidelines in relation to outsourcing contracts provide that monitoring by agencies of ESPs' compliance with privacy requirements should be undertaken on a regular basis. Shortly after the ATO Agreement commenced in June 1999, the ATO Internal Audit Branch commenced audits of the ESP's compliance with its security and privacy requirements, but had yet to complete this important task during the period of audit fieldwork. In commenting on the proposed audit report, the ATO advised ANAO in August 2000 that its Internal Audit Branch had completed its reports into *Privacy, Security and Access*, and that *'the actions to address the issues identified are being implemented.'* Group 5 and Cluster 3 were yet to undertake audits or reviews of the relevant ESP's compliance with its privacy obligations, or develop a strategy for monitoring that compliance.

Recommendation No. 19

9.80 ANAO *recommends* that, in implementing IT outsourcing arrangements, relevant agencies develop a specific strategy for monitoring external service providers' compliance with contractual privacy obligations.

9.81 Agencies responded to the recommendation as follows:

- ***Privacy Commission:*** **Agree.** If contractual clauses are to deliver effective privacy protection there needs to be a mechanism in place to ensure that both parties meet their privacy obligations.
- ***DOFA whole-of-government response:*** **Agree.** IT service agreements provide a rigorous regime for compliance with privacy obligations. Monitoring of compliance with these obligations is a matter for responsible agencies.

Account payments

9.82 The FMA Act, together with the contractual provisions of the relevant Agreements, establish the framework for the payment of public monies to the ESP by agencies. To support the FMA obligation to promote proper use of the Commonwealth resources, each agency Chief Executive issues Chief Executive Instructions (CEI) stipulating the manner in which resources must be managed within the agency.[252]

9.83 The Cluster 3, ATO and Group 5 Agreements set out provisions in respect of the rendering and payment of invoices which recognise that agencies will require the capacity to verify service charges. Each Agreement provides that:

- agencies are required to pay properly rendered invoices within 30 days after receiving the invoice unless the parties agree that the payment period is longer;
- agencies will pay undisputed charges when those payments are due, but may withhold payment of any charges that are disputed in good faith; and
- the ESP must provide the agencies with documentation and other information with respect to each invoice as may reasonably be requested by them to verify its accuracy and compliance with the provisions of the Agreement.

9.84 These requirements have been included in the Agreements to support the ability of agencies to ensure payments are made in accordance with accountability requirements and sound administrative practice. However, the provision by ESPs of accurate and appropriately substantiated and detailed invoices has proven to be an area of difficulty under each of the Agreements reviewed, particularly in the initial phases of service delivery. This, together with delays in obtaining complete and reliable performance information to help verify the quantity and quality of services received, has created difficulty for agencies in ensuring payments are made in accordance with the requirements of the FMA Act and relevant CEIs, and in ensuring cash management practices are effective. The experience of Cluster 3, ATO and Group 5 agencies has provided some important lessons for other agencies in terms of the risk management considerations that can be expected to arise in this area.

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[252] DoFA has issued model CEIs which have been generally adopted by agencies. Under the model CEI, a fundamental requirement for the appropriate payment of public moneys is that agencies have verified, either prior to payment or as part of an arrangement with the payee that allows for post-payment adjustments, that the charges are correct as to amount and that the goods/ services in respect of the account have been received or satisfactorily rendered and the conditions of the contract have been satisfied.

9.85 During the initial eighteen months of the Cluster 3 Agreement, the Cluster agencies and CMO expressed significant concern regarding the accuracy, reliability and completeness of the invoices and supporting information provided by the ESP.[253] The nature of the risk management difficulties created for Cluster 3 agencies has differed, depending upon the approach taken to the payment of service charges. In some cases, payment of all or part of invoices has been withheld pending receipt of adequate supporting documentation.[254] In those circumstances, agencies need to be aware of the contractual provisions applying to the payment of invoices, and the potential for the withholding of payments to represent breaches of those provisions.

9.86 In other cases, agencies have made immediate payment on invoices despite significant concerns regarding their accuracy, with the intention of resolving disputes once more accurate information becomes available. However, the timeliness and effectiveness of that subsequent verification has been significantly hindered by the availability of necessary supporting information from the ESP, with subsequent difficulties in being able to accurately investigate or validate service charges.[255]

9.87 For example, DIMA did not perform invoice reconciliations prior to payment for the months July 1998 to February 1999. The invoiced amount was paid on the basis that disputed amounts would be taken up when a reconciliation of the invoices was performed. In May 1999, DIMA advised the ESP that, after a review of invoices for the period July 1998 to March 1999, it would be seeking a credit of $550,000 for disputed amounts. By August 1999, the total figure in dispute for 1998-99 invoices amounted to nearly $1 million or 4 percent of invoiced charges, of which $117,000 had been deducted from payments by DIMA. Disputed amounts

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253 However, a billing issues management register was not developed until about a year into the Agreement.

254 DOFA took the approach that it would not pay invoiced amounts where adequate supporting data was not provided and, initially, withheld payment of advance payments for voice, mainframe and desktop charges for July, August and September 1998. DOFA paid those invoices in October 1998 after the ESP sought interest on the outstanding payments (as is provided under the Agreement). However, it was decided within DOFA that future advance payments were only to be made subject to reconciliation with actual invoiced amounts. Payments by DOFA have been considerably delayed at various times due to the effort involved in substantiating the payments and the delay or lack of provision of supporting information.

255 For example, in June 1999 the ESP advised the Cluster that the volume of work on invoice back adjustments was overwhelming, with some problems being unresolvable and requiring contract interpretation.

represented a cash management issue of some significance that was not resolved until November 1999, some seventeen months after the first of the affected service charges were incurred.[256]

9.88 Delays by the ESP in providing adequate supporting information for invoiced charges created particular difficulties for AEC, which had prepaid the ESP an amount of $5.5 million in June 1998.[257] The prepayment was intended to relate to services for the period July 1998 to February 1999, and for the rollout of an upgraded desktop network originally scheduled to be conducted prior to commencement.[258]

9.89 Where an agency has made a prepayment prior to satisfactory performance or delivery, it is essential that appropriate scrutiny is applied to the invoices subsequently rendered in order to ensure the Commonwealth receives appropriate value-for-money and satisfy accountability requirements. However, in addition to the absence of sufficient supporting documentation for service charges subsequently invoiced, the ESP did not provide AEC with a statement regarding the status of its prepayment until March 1999. In February 1999, AEC had noted that it would not make additional payments to the ESP until the status of the prepayment was known. The first detailed scrutiny of invoices by AEC was undertaken in June 1999, some twelve months into the Agreement.[259]

9.90 The Cluster 3 Agreement provides for the ESP to invoice the agencies in advance for significant elements of the services delivered, including mainframe services and desktop rental and support charges. The administrative difficulties experienced by Cluster 3 agencies as a result of the requirement to make payments to the ESP prior to the substantiation of service charges highlight that the inclusion of such

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[256] DIMA advised the ESP that if significant progress towards resolving the issues surrounding the disputed amounts was not made by the end of October 1999, all remaining disputed amounts for July 1998 to June 1999 invoices ($866,000) would be deducted from DIMA's next payment. After reviewing the invoice for services provided in September 1999, DIMA was not satisfied that progress had been made towards resolution of the disputed amounts and the full amount of $866,000 was deducted from the payment.

[257] The prepayment included discounts for early payment.

[258] The rollout was suspended due to the conduct of the Federal Election in September 1998 and Phase 2 of the rollout was yet to be completed as at December 1999.

[259] In June 1999, the invoices provided to AEC for February to May 1999 were scrutinised, with disputed amounts split into two categories; those disputed and unpaid, and those paid but considered to be 'in question' and subject to further review. Based on that scrutiny, AEC considered the charging in respect of mainframe services to be satisfactory, but identified that further review of the other platforms was required due to the need for an agreed asset listing, insufficient information provided by the ESP to substantiate the services charges and incorrect charging. At the time of audit, there did not appear to have been detailed scrutiny applied by AEC to the July 1998 to January 1999 invoices applied against the prepayment.

provisions may not support appropriate resource management by agencies.[260] This is particularly the case in light of the extended delays that have been experienced in resolving discrepancies and queries regarding invoicing. Although progress and improvement has been achieved in this regard, this has required the application of significant effort and resources by the CMO and Cluster agencies, thereby distracting those resources from other areas of contract management. In commenting on the proposed audit report, the Cluster 3 ESP advised ANAO that:

> *As with other aspects of the Agreement, there is a gap in expectation on either side related to the payment of accounts.* [We have] *had to undertake a major review of* [our] *Asset Tracking and Billing systems to meet the particular needs of Government accountability. This review is still in process.*

9.91 Like Cluster 3, invoice processing under the ATO and Group 5 Agreements has been problematic, with extended delays experienced in obtaining appropriately substantiated invoices for the first six months of service delivery. In August 2000, the ATO ESP advised ANAO that it had provided the first invoices to the ATO in August 1999, and that, on receipt of these invoices, the ATO had indicated that it required additional information to substantiate them. The ATO ESP advised ANAO that *'clarifying these requirements has taken considerable time.'* The general practice of the ATO has been to pay invoiced amounts that can be verified, but to withhold payment on discrepancies identified pending resolution or substantiation.[261]

9.92 Initially, this was also the practice of Group 5 agencies. However, in May 2000, PM&C and DoTRS advised ANAO that they were now paying the full invoice amount in the first instance, and awaiting acceptance by the ESP of corrections identified in subsequent reconciliations. As has been the case in Cluster 3, there have been considerable delays experienced in completing those reconciliations. In May 2000, DoTRS had yet to reconcile charges paid on the invoices rendered for October 1999 onwards.

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260 For example, an independent consultant engaged by DIMA in December 1998 to advise on the allocation of costs under the accrual budgeting outcomes/outputs regime, reported that the billing arrangement requiring payment in advance appeared to be causing a significant amount of trouble for both parties. The consultant reported that for DIMA, this makes analysis, cost-control and budgeting difficult.

261 Particular difficulties have been experienced in telecommunications invoicing. As at June 2000, the ATO was yet to make payment in respect of those services for the first year of the Agreement.

9.93 The invoicing difficulties experienced by Group 5 agencies have been in large part due to the quality of the asset information on which the service charges have been based, with a number of agencies taking some months to agree an asset listing with the ESP. This has resulted in delays in the submission of invoices, additional reconciliation effort on the part of agencies, and delays in payment to the ESP. In August 2000, the Group 5 ESP advised ANAO that:

> *There have been delays in reconciliation of the pooled service credit arrangement which has an impact on service credits and invoice reconciliation. There are discussions currently under way between the Commonwealth and* [ourselves] *with the aim of streamlining the procedures based on operational experience.*

9.94 Asset management was also a cause of difficulties for Cluster 3 agencies, where it was exacerbated by the need to implement substantial equipment replacement programs. The experience of these agencies has highlighted the importance of an agreed and accurate asset baseline to provide a sound basis for the management and invoicing of services by the ESP. Placing particular focus on this area during the transition period will be of significant benefit to agencies involved in future IT outsourcing agreements.[262]

9.95 The use of prepayments, or the immediate payment of invoices subject to a subsequent verification and adjustment process, can be appropriate in certain situations. However, such approaches require the application of appropriate risk management techniques. In particular, it is important that the subsequent verification process is conducted in a timely manner, and that the Commonwealth's cash management position is protected within the terms of the Agreement. In general, the longer the period of time that elapses between the rendering of a service and the verification of the fee charged, the higher will be the risk associated with the ability of agencies to ensure payments have been appropriately made.

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[262] For example, in providing advice to the Group 5 agencies on contract management arrangements, the DIMA contract manager recommended that agencies make sure they have an accurate and detailed infrastructure baseline that is agreed by both parties. It was recommended that agencies spend the money on another stocktake if there is any uncertainty as to the asset baseline that is being handed over.

9.96 The experiences of Cluster 3, ATO and Group 5 agencies have highlighted that the ability of the ESP to provide the invoicing data required to support agencies in satisfying their FMA obligations and internal budgetary requirements is an area on which agencies involved in future IT outsourcing agreements will need to place particular focus. Appropriate consideration of the ESP's capacity in this area prior to the commencement of the Agreement will also be important in informing agencies' risk management decisions regarding the approach to be taken to the payment of invoices from the ESP. ANAO considers that it would be of benefit to agencies to conduct verification of ESPs' invoices prior to making payment.

9.97 **Finding:** The provision by ESPs of accurate and appropriately substantiated and detailed invoices has proven to be an area of difficulty under each of the Agreements reviewed, particularly in the initial phases of service delivery. This has created difficulty for agencies in ensuring payments are made in accordance with the requirements of the FMA Act. The general practice of the ATO has been to pay invoiced amounts that could be verified, but to withhold payment on discrepancies identified during the verification process pending resolution or substantiation. The approach by Cluster 3 and Group 5 agencies to the payment of invoices has varied. In some cases, payment of all or part of invoices has been withheld pending receipt of adequate supporting documentation. In other cases, agencies have made immediate payment on invoices despite significant concerns regarding their accuracy, with the intention of resolving disputes once more accurate information became available. However, the timeliness and effectiveness of that subsequent verification has been significantly hindered by the availability of necessary supporting information.

9.98 The experiences of Cluster 3, ATO and Group 5 agencies have highlighted that the ability of the ESP to provide the invoicing data required to support agencies in satisfying their FMA obligations and internal budgetary requirements is an area on which agencies involved in future IT outsourcing agreements will need to place particular focus. Appropriate consideration of the ESP's capacity in this area prior to the commencement of the Agreement will also be important in informing agencies risk management decisions regarding the approach to be taken to the payment of invoices from the ESP. ANAO considers that it would be of benefit to agencies to conduct verification of ESPs' invoices prior to making payment.

Recommendation No. 20

9.99 ANAO *recommends* that, in future IT outsourcing processes, relevant agencies:

a) ensure that the capacity of tenderers to provide the invoicing information and associated documentation required to support the approval of Commonwealth payments and agency budgetary purposes is appropriately assessed during the tender evaluation and transition phases;

b) specify in the outsourcing Agreement threshold invoice requirements that must be met before payment can be made; and

c) consider including in the transition milestones and deliverables required to be met in order for the external service provider (ESP) to receive full payment of transition fees, a requirement that the ESP demonstrate adequate capacity to provide invoicing that will satisfy the specified threshold requirements.

9.100 Agencies responded to the recommendation as follows:

- ***DOFA whole-of-government response:***
  - Part (a): **Agree**, tender evaluations now place greater emphasis on these matters in light of the experience of earlier groups.
  - Part (b): **Agree with qualification.** Any threshold requirements must be flexible to allow agencies to make judgements about the materiality and value of supporting invoice data and materials.
  - Part (c): **Agree** that this requirement should be considered.

Canberra, A.C.T.
6 September 2000

P. J. Barrett
Auditor-General

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