

Issues and Conclusions

The Mulwala Agreement

- 3.1 The Committee accepted that the redevelopment of Mulwala was an important strategic requirement in the context of the Commonwealth's commitment to retaining a long term domestic production of propellant and high explosives¹.
- 3.2 However, the Committee expressed some reservations on a number of issues falling within the terms of the Mulwala Agreement between the Commonwealth through Defence as its agent and Thales Australia, including leasing arrangements, the capability payment, and the responsibilities of the parties to the Agreement.

Leasing Arrangements

- 3.3 Defence explained that the Mulwala Agreement was initially negotiated with the former Australian Defence Industries, and renegotiated with the new owners Transfield Industries and Thales in 1999². This arrangement continues to be in effect under Thales Australia. Thales currently has a lease over Mulwala until 30 June 2015³.

1 Appendix C, Submission No. 1, paragraphs 1 and 4.

2 Appendix D, Official Transcript of Evidence, page 2.

3 Appendix E, Submission No. 3, paragraph. 3.

- 3.4 Defence also informed the Committee that in 2008 the Commonwealth will make a decision as to whether it will extend Thales' lease beyond 2015 to 2025⁴. However it was not clear as to whether Thales Australia could exercise a similar option, that is, whether Thales Australia had an option not to extend its lease beyond 2015.
- 3.5 The Committee has subsequently learned that Thales Australia can only vacate the lease on two grounds: in circumstances where the Commonwealth exercises its options to terminate the lease or allow it to expire, or where there is a failure of the Commonwealth to remedy a situation that would otherwise be in breach of Environmental or Occupational Health and Safety law.
- 3.6 Leasing arrangements were a factor for Thales Australia. The company informed the Committee that on taking over the facility it sought certainty as to how long it would be operating Mulwala and whether it would need to enter into some new arrangement for the supply of propellant to its munitions factory at Benalla in Victoria. The Mulwala Agreement offered a level of confidence for the company to continue with its operations at Mulwala⁵.
- 3.7 According to the company the Mulwala Agreement was amended to update the lease, and in addition to other obligations, provide a capability to manufacture and supply a specified quantity of propellant and a specified quantity of explosives to the ADF for which the Commonwealth makes a capability payment.
- 3.8 The company informed the Committee that on the matter of rentals paid to the Commonwealth, the capability payment far exceeds the amount of rent payable under the terms of the Mulwala Agreement⁶.
- 3.9 In responding to the Committee's question as to whether the rental paid to the Commonwealth was based on current market rates, Defence informed the Committee it was unaware of the current market rates that could be applied to the lease of Mulwala⁷. Subsequently the Committee learned that no market survey of rentals was conducted because to do so in the case of Mulwala was inappropriate because the facility is not operated as a commercial enterprise.
- 3.10 Similarly, Thales Australia stated in evidence that:

4 Appendix D, loc. cit

5 *ibid.*, p. 3

6 *ibid.*, p.4

7 *ibid.*, p.3

[The] Mulwala facility as it stands is not a commercial enterprise and never could be operated as a commercial enterprise, which is why the Commonwealth pays a capability payment. When Thales recently became 100 percent Australian owned, the board of directors of Thales Australia and Thales' parent company were required to make a number of undertakings to the Commonwealth to protect the national interest and the defence interest. They included the continuing provision of propellants and ammunition out of the Mulwala and Benalla facilities⁸.

- 3.11 Whilst the matter of commerciality is moot, it is accepted practice where purpose-built buildings have been provided for the benefit of a tenant, rents are gauged by comparable rental payments in the market place; however because it was decided by Defence that it was inappropriate to undertake a market survey of comparable rents for purpose built buildings, the Commonwealth has been placed in a position of offering significant subsidies to Thales Australia in the performance of its operations.

Recommendation 1

The Committee recommends that at the time of renegotiating the lease of Mulwala in 2008 between Thales Australia and the Commonwealth, Defence consider bringing rental payments into line with current market rental payments for purpose built buildings.

The Capability Payment

- 3.12 The extent of the Commonwealth's undertakings to Thales Australia under the terms of the Mulwala Agreement is significant. The capability payment is of such magnitude that it offsets rentals charged by the Commonwealth as well as rates and charges levied by local Council and the New South Wales Government that under the Mulwala Agreement are 100% attributable to capability costs.
- 3.13 That the company has been able to produce a product surplus, evidenced by commercial sales of product, it is a reasonable conclusion that the requirements of the ADF have been met, but the capability payment has not been adjusted to meet this situation.

- 3.14 The Committee has also learned that there are a range of other indirect costs that are paid by the Commonwealth through the capability payment to Thales Australia.
- 3.15 Against this background, the provisions of the Mulwala Agreement including those related to payments made to Thales Australia may be skewed in favour of the company, leaving the Commonwealth in a less than advantageous position.

Recommendation 2

The Committee recommends that Defence consider renegotiating the capability payment paid by the Commonwealth to Thales Australia in recognition that production at the Mulwala facility exceeds the demands of the ADF, and has the capacity to service commercial markets.

Project Costs

- 3.16 The Committee expressed the view that the issue of leasing arrangements had a significant bearing on the costs associated with the proposed project. At an estimated outturn cost of \$338.7 million (excluding GST)⁹ the Committee was keen to seek some guarantees from Defence that if in the future Thales Australia made a commercial decision to relinquish the lease of the facility, there existed an alternative plan for its use to avoid significant expenditure on a redevelopment proposal that by 2015 could well become surplus to requirements¹⁰.
- 3.17 The Committee questioned whether in these circumstances the redevelopment of the Mulwala facility represented sound expenditure of public money¹¹.
- 3.18 In the view of the department the question of occupier/operator was not an issue. According to Defence, the Commonwealth made a commitment in 2001 to retain a long-term domestic production of a propellant manufacturing capability at Mulwala, regardless of whether Thales Australia operates the plant or some other operator takes over from Thales Australia, including possibly Defence itself in the event of no other commercial interest. Underpinning the department's response was the

9 Appendix C, paragraph 26

10 Appendix D, pp. 4 and 11

11 *ibid.*, p.4

point that the ADF needs munitions to undertake its role and that consequently the demand for propellant was ongoing¹².

- 3.19 In addition to the prime project cost of \$338.7 million (exclusive of GST) the department's Statement of Evidence also referred to an additional amount of \$63 million for certain environmental remediation works that had been identified as having originated from earlier operations conducted at the facility¹³.
- 3.20 The Committee sought an explanation as to why these proposed works were not part of the current proposal now being considered, since it appeared that the total cost of the proposal was not \$338.7million but in fact up around \$400 million¹⁴.
- 3.21 In response the department informed the Committee that the \$63 million was quarantined from the current project because it involved a different scope of work. It was explained that the additional funds will provide a capability to monitor the flow of sulphate and nitrate contamination plumes that are flowing slowly toward the Murray River; develop and implement remediation action plans to protect the water quality of the river and of the groundwater aquifer; excavate and dispose of contaminated material; use in situation carbon source addition, that allows bacteria to breakdown the contamination within the soil; cap some of the contaminated areas so that they cannot be exposed to the public and to the ambient air, and use hydraulic containment to stop the flow of contaminants towards the Murray River¹⁵.
- 3.22 Defence also informed the Committee that in addition to the prime project cost of \$338.7 million there will be ongoing annual expenditure on maintenance and capital improvement; however the department did not elaborate on what those works would comprise¹⁶.

Revenue Stream

- 3.23 The Committee sought information regarding revenue streams associated with both the facility as it stands currently and potential revenue streams following on the redevelopment. Of particular interest to the Committee were revenue streams derived from leasing arrangements between Thales

12 *ibid.*, pp. 2 and 11

13 Appendix C, paragraph 14.

14 Appendix D, p. 4

15 *ibid.*, pp. 6-7

16 Appendix C, paragraph 25.

Australia and the Commonwealth (addressed above) and the opportunity for increased profit.

- 3.24 In discussion during the Hearing on the potential revenue that Mulwala might deliver to the Commonwealth, the view was expressed that the arrangements under which it occupies Mulwala are not commercial. This would appear to be at odds with statements made by the Thales Australia witness. Of particular note was the statement regarding excess capacity at the facility. The witness stated:

...Thales Australia uses the excess capacity at the Mulwala facility – and proposes to in the future – to sell propellants commercially. We sell a substantial quantity, particularly on the export market, with the US being a principal customer. We would expectto use that spare capacity to the maximum¹⁷.

- 3.25 During the Confidential Briefing, the Committee discussed the issue of profit sharing and revenue flowing to the Commonwealth under the terms of the Mulwala Agreement, and had some concerns with the split between the Commonwealth and Thales Australia. The Committee inferred that the significant expenditure of Commonwealth monies on the redevelopment of Mulwala ought to deliver a better return on investment than was currently available¹⁸.
- 3.26 It does not appear however that the existing arrangement for the distribution of profit has been renegotiated with Thales Australia, particularly against a background of a major facility redevelopment that will deliver significant efficiencies to the lessee.
- 3.27 In real terms any potential financial benefit to the Commonwealth is overtaken by the need to meet capability payments.
- 3.28 On the basis of the evidence presented by the department, the arrangement between Thales Australia and the Commonwealth presents some anomalies principally that the project is revenue negative.
- 3.29 Essentially the project commits Commonwealth monies to the redevelopment of a site occupied by a privately owned company for which it receives no return on its investment. Indeed the potential for revenue is denied by virtue of the arrangements that Defence has put in place on behalf of the Commonwealth, that include ongoing capability payments to the company, accompanied by an inequitable split of profit sharing arrangements.

17 *ibid.*, p. 11

18 *ibid.*, p. 3

Recommendation 3

The Committee recommends that at the earliest opportunity Defence adjust the profit sharing ratio so as to deliver an outcome that is more equitable to the Commonwealth, recognising the improvements in operational efficiencies that the redevelopment provides to the lessee.

Environment and Heritage Issues

- 3.30 The Committee sought clarification of the measures being taken at Mulwala for the supply and storage of water used in the manufacturing of propellant.
- 3.31 Defence informed the Committee that currently Mulwala has a water licence with the Corowa Shire to draw 700 megalitres from the Murray River, of which approximately 200 to 300 megalitres is returned to the river system¹⁹. According to Defence the new plant that is to be installed will provide the opportunity for the reuse of water collected by condensation, which after treatment will also be returned to the Murray. This would be in the order of 250 megalitres²⁰.
- 3.32 The Committee was satisfied on the evidence presented by Defence that all water returned to the riverine system would satisfy EPA standards²¹.
- 3.33 On the matter of groundwater remediation, the Committee sought clarification as to whether, given that the redevelopment of the new plant would occur leaving the existing plant in situ until the new plant had been commissioned, the extent of ground water contamination might be more extensive than the site identified by Defence for which an amount of \$63 million had already been allocated. Additionally the Committee asked whether the decommissioning and retention of old buildings for heritage reasons was integral to the redevelopment of Mulwala²².
- 3.34 In responding, Defence informed the Committee that:
- ...Once the plant is decommissioned, we will do a complete heritage and environmental assessment of what is there and determine what can be done, and then we will implement it.²³

19 Appendix D, p. 5

20 *ibid.*

21 *ibid.*, p. 6

22 *ibid.*, p. 8

23 *ibid.*

- 3.35 The department also explained that a heritage management plan will dictate how the site will be managed. Defence also confirmed that these future works were not part of the current project owing to the uncertainty of the work that might need to be done after the old plant has been decommissioned²⁴.
- 3.36 Defence also explained that following decommissioning any environmental issues will be dealt with, including the removal of acids, nitrates and nitrocellulose from decommissioned buildings, which will have the effect of also removing any further leaching into groundwater²⁵.

Local Employment Opportunities

- 3.37 The Committee sought clarification on the matter of employment generation, noting that in the submission received from Thales Australia there was an indication of savings in labour costs as well as an indication that there would be increased employment generation²⁶.
- 3.38 Defence informed the Committee that:
- ...during the construction phase we estimate that there will be of the order of 250 to 280 jobs that will be generated.....Once the commissioning is finished, there is an estimate of some reduction in the workforce.²⁷
- 3.39 Thales Australia expanded on the department's response, adding that:
- Once the new facility is operational we expect that – but we have not seen the detailed design - if we remove our employees from hazardous processes and exposure to chemicals and have some automated materials handling somewhere between 30 to 50 employees would not be required in the future²⁸.

Quality of Evidence

- 3.40 The Committee considered that the quality of evidence provided by departmental officials at both the Confidential Hearing and the Public

24 *ibid.*

25 *ibid.*, p. 9

26 *ibid.*, p. 10

27 *ibid.*

28 *ibid.*

Hearing, and in Statement of Evidence should have been more comprehensive. Issues related to the terms of the Mulwala Agreement, including leasing, the capability payment, and opportunities for the delivery of profit to the Commonwealth are particularly complex, but are nevertheless subject to Committee scrutiny. As evidenced by the extent of follow-up required to satisfy the Committee both the oral evidence provided by the department and the documentation was very narrowly focussed, and should have been more transparent.

Recommendation 4

The Committee recommends that Defence examine how in future hearings associated with major capital works proposals, the quality of evidence can be enhanced in order to make it more comprehensive, and more transparent.

Recommendation 5

The Committee recommends that Defence submit a strategy report to the Committee on how the department proposes to address the issues referred to in Recommendations 1, 2, and 3.

Recommendation 6

The Committee recommends that the redevelopment of the propellant manufacturing facility at Mulwala proceed at an estimated cost of \$338.7 million, excluding GST.

The Hon Judi Moylan MP

Chair

28 March 2007