

# Chapter 12

## Findings on due diligence and other relevant matters

12.1 In this chapter, the committee provides its findings and recommendations in relation to the balance of its four key areas of concern. The areas remaining for consideration are:

- *matters of due diligence*—whether the tender respondents (and their key personnel and associated companies) were fit and proper persons to contract with the Commonwealth, and possessed the financial and commercial capacity to deliver the contracted services to the requisite quality and standard.<sup>1</sup>
- *other relevant matters*—any further issues concerning the probity of the procurement and the tender respondents.<sup>2</sup>

### Due diligence on tender respondents

12.2 The committee is required by its terms of reference to consider the following matters in respect of tender respondents, their key personnel and associated companies:

- the adequacy of the due diligence process around the choice of potential suppliers from standing offer panels and, more specifically, whether there was existing or any subsequently discovered evidence to warrant non-selection of any of the panel members, or whether the information obtained should have resulted in further inquiry and investigation;<sup>3</sup>
- whether the respondents, including directors and other key personnel (whether employees, agents or contractors nominated in the tender response) for the proposed contracts, are fit and proper for the purpose of contracting with the Commonwealth, and the adequacy and methodology of this process;<sup>4</sup>
- the adequacy and appropriateness of the processes in determining:
  - whether the respondents and associated companies supplying services to the respondents have the financial and commercial capacity to deliver the services submitted in their responses;<sup>5</sup>

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1 Terms of Reference, paragraphs (a)(i),(viii); (b)(i)-(iv).

2 Terms of Reference, paragraph (b)(v).

3 Terms of Reference, paragraph (a)(i).

4 Terms of Reference, paragraph (a)(viii).

5 Terms of Reference, paragraph (b)(i).

- whether the respondents have the capacity to deliver the services submitted in their responses to a quality and standard that meets the requirements of the Commonwealth and its regulatory authorities and, if so, whether the department was fully satisfied with the services provided by the foreign carrier when they last provided such services;<sup>6</sup>
- whether the department is in a position to guarantee the security status of all foreign personnel involved in the air transportation of troops between mainland Australia and its deployment base adjacent to a war zone;<sup>7</sup> and
- whether issues relating to the respondents, or their related companies, about their contracts in South Africa are such as to warrant their exclusion from consideration on ethical or probity grounds.<sup>8</sup>

### *Matters of concern*

12.3 The committee has limited its examination to Adagold—as the current contract holder—and the company's key personnel and associated entities. The committee comments below on the following matters of concern:

- the assessment by Defence of Adagold's fitness and propriety to contract with the Commonwealth—namely, the consideration of the company's connection to South African tender controversies; its association with Major Charlton; and the safety record of Hi Fly;
- Adagold's financial and commercial capacity; and
- Adagold's capacity to deliver the contracted services to the required quality and standard.

### *Fit and proper persons*

12.4 The committee notes the findings of the Deloitte Review on allegations about Adagold's connection with South African tender irregularities; its association with Major Charlton; and the safety record of Hi Fly.<sup>9</sup> For the reasons identified in chapter 8, the committee makes no findings on the substance of these allegations, but records its concern that these matters did not appear to have been the subject of due diligence during the initial tender evaluation process.

12.5 In particular, it is unclear how, if at all, the TEP and tender evaluation process considered reputational issues or other matters concerning tender respondents' general

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6 Terms of Reference, paragraph (b)(ii).

7 Terms of Reference, paragraph (b)(iii).

8 Terms of Reference, paragraph (b)(iv).

9 Deloitte Review, pp. 21–24 (terms of reference, paragraph 4.6).

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fitness and propriety to contract with the Commonwealth. Given the small and competitive nature of the air charter market, the committee is of the view that such matters—and the assessment of their associated risks—should be addressed expressly in the TEP.

12.6 The committee notes the findings of the Deloitte Review that there did not appear to be any criteria within Commonwealth or Defence procurement policy that specify requirements for being 'fit and proper' for the purposes of contracting with the Commonwealth. Nor did Deloitte identify any authoritative guidance on the relevant searches to be undertaken in assessing a respondent's fitness and propriety to contract with the Commonwealth. The committee observes that Deloitte assessed fitness and propriety in terms of whether proceeding to contract with the relevant tenderer could cause the Commonwealth reputational damage.<sup>10</sup>

12.7 In the committee's view, the overall fitness and propriety of potential Commonwealth contractors falls squarely within an assessment of value for money. Value for money requires a comparative analysis of all relevant costs and benefits of a proposal—that is, both financial and non-financial—over the entire procurement life-cycle. Two key considerations identified in the CPGs are 'fitness for purpose' and 'the performance history of each prospective supplier'.<sup>11</sup>

12.8 Accordingly, the committee considers that the overall fitness and propriety of tender respondents, their key personnel, proposed sub-contractors and associated entities should be assessed routinely in all future procurements of air sustainment services to the MEAO. Future TEPs should include criteria setting out requirements or indicators for assessing a tenderer's fitness and propriety to contract with the Commonwealth. TEPs should also identify key searches that should be performed in undertaking assessments, and provide guidance on the possible implications of the outcomes of those searches. These criteria, indicators, searches and relevant persons and entities should be based on those outlined in the Deloitte Review.<sup>12</sup>

12.9 In developing guidance on the consequences of relevant search results, the sole focus should not be on identifying factors that would automatically disqualify a respondent from further consideration. In this respect, the performance of 'fit and proper' inquiries in the first instance should be broader than the task of the AFCD and Deloitte reviews. Those reviews were concerned with identifying reasons that the tender process should not continue. While these factors are clearly important, consideration should also be given to the risk of reputational damage associated with entering into a contract with a respondent who is subject to allegations of impropriety. The potential risk for proponent grievances on the basis of such allegations should also be considered.

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10 Deloitte Review, p. 23.

11 CPGs, Division 1, Part 4—Value for Money.

12 Deloitte Review, pp. 21–23.

**Recommendation 6**

**12.10 The committee recommends that in all future procurements of air sustainment services to the MEAO, Defence develops and implements tender evaluation processes for assessing respondents' fitness and propriety to contract with the Commonwealth. Such evaluation processes should:**

- (a) identify criteria setting out requirements or indicators for being 'fit and proper' to contract with the Commonwealth;**
- (b) specify searches that may be conducted on tender respondents, their key personnel, proposed subcontractors and any associated companies (for example, parent or subsidiary companies)—including guidance on the scope of the searches;**
- (c) identify the possible implications of the findings of each of the specified searches; and**
- (d) enable the identification and assessment of potential risks arising from issues identified in these searches including:**
  - (i) reputational damage to the Commonwealth, should it proceed to contract with the relevant tenderer; and**
  - (ii) proponent grievances about the relevant tenderer's fitness and propriety to contract with the Commonwealth.**

***Financial and commercial capacity***

12.11 The committee supports the decision to obtain a performance guarantee from Adagold, and to execute a novation agreement between the Commonwealth, Adagold and Hi Fly. These are appropriate risk management measures having regard to Adagold's business structure and financial position.

12.12 The committee notes, however, two key findings of the Deloitte Review that identified shortcomings in the financial evaluation of tender responses. Firstly, the Deloitte review found that the particular risks arising from the sub-contracting arrangements in Adagold's tender response were not initially identified in the assessment undertaken by the FIS team. Deloitte observed that Adagold was assessed as 'medium risk', suggesting that a performance guarantee may not have been required.

12.13 Given that the membership of the Air Transport Standing Offer Panel includes several charter brokers, the committee considers that future tender evaluation documentation—at least for high value contracts such as the MEAO contract—should contain specific provisions on conducting financial risk assessments of tender responses involving charter broker arrangements.

12.14 Secondly, the Deloitte Review identified a further instance in which the circumstances of charter brokers did not appear to have been adequately considered. Under the terms of the request, tender respondents were required only to submit the

financial statements of 'the contractor' and not their sub-contractors.<sup>13</sup> The Deloitte Review indicated that some proponents of broker-based solutions submitted limited financial information on their subcontractors.<sup>14</sup>

12.15 Accordingly, the committee considers that all future requests should require tender respondents submitting broker-based solutions to provide the complete financial statements of their proposed sub-contractors.

### **Recommendation 7**

**12.16 The committee recommends that Defence includes, in all future tender evaluation documentation for the procurement of air sustainment services to the MEAO:**

- **specific provisions on conducting financial risk assessments of tender responses involving charter broker arrangements; and**
- **essential requirement that proposals involving any form of broker-based solution—including sub-contracting arrangements—must include the complete financial statements of the proposed air charter operator and any other proposed sub-contractors.**

### *Capacity to deliver the contracted services to the requisite quality and standard*

12.17 In addition to its earlier comments on the limitations of the external reviews of the tender process, the committee comments on two further issues. First, in its submission to the committee CASA identified a possible limitation in Defence's understanding of the application of the civil aviation safety regulatory regime in respect of charter broker arrangements. CASA stated that:

Charter brokers have no regulatory obligations to CASA, and CASA has no authority to regulate these charter brokers. It is only operators—AOC and FAAOC and permission holders—who must comply with the applicable safety requirements and over whose conduct CASA has any regulatory authority.

Depending on the nature of the arrangements involved in any given case, it is possible that the Department of Defence may not have a clear or complete understanding about the *operator* that will actually be performing the air services contemplated by the contract, as opposed to the charter broker with whom the Department will have dealt.<sup>15</sup>

12.18 In light of this comment, the committee encourages Defence to ensure that all personnel involved in the procurement of air charter services understand the operation of the civil aviation regulatory framework in respect of charter broker arrangements.

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13 Deloitte Review, pp. 25–26.

14 Deloitte Review, p. 25.

15 Civil Aviation Safety Authority, *Submission 7*, p. 3.

12.19 Second, while acknowledging that Defence has indicated its general satisfaction with Adagold's contractual performance to date, the committee notes the performance reporting, review and management provisions in the deed and the request. The outcomes of future performance assessment under these provisions are of interest to the committee.

*Independent, expert scrutiny and continuing monitoring*

12.20 Finally, while welcoming the reform program announced by Defence, the committee is concerned to ensure that:

- there is an independent, expert assessment of the lessons learned from the tender—particularly in respect of probity risk management; and
- the implementation of these reforms is monitored closely—especially to ensure that policy reforms are reflected in procurement practice.

12.21 In the committee's view, the Auditor-General would be well placed to conduct two further reviews of the procurement—first, to assess the immediate lessons learned from the 2010 tender process, and subsequently to assess Defence's progress towards implementing reforms.

**Request to Auditor-General**

**12.22 The committee requests that the Auditor-General:**

- **Conduct a performance audit of the tender process in respect of RFT AO/014/09, with a focus on probity risk management. In particular, the audit should evaluate the following matters, with a view to identifying any further areas for future improvement:**
  - (a) **Defence's governance arrangements for the identification and management of significant probity risks to the procurement process, including conflicts of interest, confidentiality and proponent grievances;**
  - (b) **Defence's program of procurement governance and process reforms, including those outlined in its evidence to the committee; and**
  - (c) **any other matters considered relevant to probity risk management, or related governance matters, in respect of the procurement of air sustainment services to the MEAO.**
- **After sufficient time has elapsed, conduct a second review to examine Defence's implementation of its program of procurement governance and process reforms. In particular the review should:**
  - (a) **evaluate the implementation progress and impact of the reforms outlined in Defence's evidence to the committee; and**

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- (b) **recommend, as necessary, any further reforms to probity risk management and other governance arrangements in respect of the procurement of air sustainment services to the MEAO.**

### **Recommendation 8**

**12.23 The committee recommends that Defence report back to the committee by 1 May 2012 on the progress being made to implement the reforms it has announced including:**

- **the ongoing performance of the 2010 contract, including the cost per mission, the realisation of projected savings, the continuing need for the increased cargo volumetric requirements and the contractor's compliance with the tender requirements;**
- **progress on the establishment of the Centre of Excellence that is intended 'to support a more robust and consistent commercial approach to non-equipment procurement';**
- **the work of the newly created Non-Equipment Chief Procurement Officer; and**
- **the strategies for the recruitment and retention of suitably skilled procurement professionals.**

### **Broader application of the committee's recommendations**

12.24 Consistent with its terms of reference, the majority of the committee's recommendations are specific to the procurement of air sustainment services to the MEAO. However, the committee recognises that the principles and practices underpinning them are of broader application to other procurements, particularly non-equipment procurements. Accordingly, Defence should also consider giving these recommendations broader application as part of its program of non-equipment procurement policy reforms.

### **Recommendation 9**

**12.25 Although the majority of recommendations apply to the procurement of air sustainment services to the MEAO, the committee recommends that Defence consider incorporating the principles and practices underpinning them as part of Defence wide non-equipment procurement policy.**

### **Conclusion**

12.26 The reviews of the 2010 tender identified deficiencies in the process but, overall, concluded that the flaws were not sufficiently material to render the process unsound. The committee is strongly of the view that Defence should not take comfort from these findings. Aspects of the tender process were sloppy and, in light of the nature of the industry and the behaviour of people in the industry, Defence was particularly inattentive when it came to identifying and managing probity risks. The committee is critical of Defence's heavy reliance on the reviews to salvage the

reputation of the tender process. The reviews were concerned with identifying whether Defence had satisfied the barest minimum requirement that would avoid invalidation of the tender process. Bare compliance is not a desirable procurement outcome.

12.27 The committee remains concerned that the image and reputation of Defence has been diminished by the circumstances which prompted the significant parliamentary and public scrutiny of the 2010 tender process. The incident has demonstrated a lack of understanding, on the part of Defence, of the critical need to identify, assess and manage probity risks effectively.

12.28 The committee is especially concerned that the risks associated with perceived conflicts of interest and the potential for proponent grievances were not afforded appropriate weight in the circumstances of the procurement. Defence possessed significant knowledge of the competitive nature of the market and the long history of controversy associated with the MEAO contract. Despite this knowledge, it failed to implement measures to enable the systematic identification and management of potential probity risks arising from these circumstances—for example, documenting a probity plan, integrating probity issues into the risk assessment framework and appointing a probity advisor.

12.29 Accordingly, the committee cannot accept that these probity risks were identifiable only in hindsight. In the committee's view, they were foreseeable from the commencement of the procurement and should have been given due consideration in risk assessment. Defence's emphasis on the benefits of hindsight<sup>16</sup> and the non-mandatory nature of probity plans and advisors<sup>17</sup> has done little to allay the committee's concerns about the Department's level of insight into probity risk management.

12.30 While the lessons emerging from this incident need not have been learned at such significant cost, the committee welcomes the reforms announced by Defence during the inquiry. These measures may go some way towards addressing the governance and procedural shortcomings evident in the 2010 tender process. The committee has made recommendations for further reforms to enhance those already in train. It has also requested the Auditor-General to conduct a review of the tender process and the reforms announced by Defence, to identify any additional lessons to be learned.

12.31 The committee has highlighted the need for ongoing monitoring of the implementation and effects of these reforms. It is concerned to avoid an 'implementation gap' between documented policy reforms and procurement practice. Accordingly, it has requested the Auditor-General to conduct a second review

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16 AFCD Review, p. 12; Mr Geoffrey Brown, *Proof Committee Hansard*, 29 March 2011, p. 88; Dr Ian Watt, *Proof Committee Hansard*, 29 March 2011, p. 88.

17 Department of Defence, *Submission 5*, Attachment A, p. 22;



examining Defence's implementation of these reforms after a suitable time has elapsed.

12.32 The committee also notes the importance of ongoing parliamentary scrutiny of Defence's progress towards implementing reforms, and the performance of the 2010 contract and any subsequent contracts and has recommended that Defence provides periodic updates on these matters.

**SENATOR ALAN EGGLESTON**  
**CHAIR**

