



COMMONWEALTH OF AUSTRALIA

# Official Committee Hansard

## SENATE

FINANCE AND PUBLIC ADMINISTRATION REFERENCES  
COMMITTEE

**Reference: The government's information technology outsourcing initiative**

TUESDAY, 5 DECEMBER 2000

CANBERRA

BY AUTHORITY OF THE SENATE

## **INTERNET**

The Proof and Official Hansard transcripts of Senate committee hearings, some House of Representatives committee hearings and some joint committee hearings are available on the Internet. Some House of Representatives committees and some joint committees make available only Official Hansard transcripts.

The Internet address is: **<http://www.aph.gov.au/hansard>**

To search the parliamentary database, go to: **<http://search.aph.gov.au>**

**SENATE**  
**FINANCE AND PUBLIC ADMINISTRATION REFERENCES COMMITTEE**

**Tuesday, 5 December 2000**

**Members:** Senator George Campbell (*Chair*), Senator Watson (*Deputy Chair*), Senators Buckland, Lightfoot, Lundy and Ridgeway

**Substitute members:** Senator Stott Despoja for Senator Ridgeway

**Participating members:** Senators Abetz, Allison, Brown, Calvert, Carr, Chapman, Conroy, Coonan, Crane, Eggleston, Faulkner, Ferguson, Ferris, Gibson, Harradine, Harris, Knowles, Mason, McGauran, Murphy, Murray, Payne, Tchen and Tierney

**Senators in attendance:** Senators Buckland, George Campbell, Conroy, Lundy and Watson

**Terms of reference for the inquiry:**

For inquiry into and report on:

The Government's information technology (IT) outsourcing initiative in the light of recommendations made in the committee's report, *Contracting out of government services—First Report: Information technology*, tabled in November 1997, and the Auditor-General's report No. 9 of 2000-2001, and the means of ensuring that any future IT outsourcing is an efficient, effective and ethical use of Commonwealth resources, with particular reference to:

(a) the need for:

- (i) strategic oversight and evaluation across Commonwealth agencies,
- (ii) accountable management of IT contracts, including improved transparency and accountability of tender processes, and
- (iii) adequate safeguards for privacy protection and security;

(b) the potential impact on the capacity of agencies to conduct their business;

(c) savings expected and achieved from IT initiatives; and

(d) the means by which opportunities for the domestic IT industry, including in regional areas, can be maximised.

**WITNESSES**

**BARRETT, Mr Patrick Joseph, Auditor-General, Australian National Audit Office ..... 1**

**CRONIN, Mr Colin Douglas, Executive Director, Performance Audit, Australian National Audit Office ..... 1**

**HAWLEY, Mr John, Acting Executive Director, Performance Audit, Australian National Audit Office ..... 1**

**LONG, Ms Tina Therese, Audit Manager, Performance Audit, Australian National Audit Office ..... 1**

**McPHEE, Mr Ian, Deputy Auditor-General, Australian National Audit Office ..... 1**

**O'BRIEN, Ms Lynne Maree, Executive Director, Assurance Audit Services, Australian National Audit Office ..... 1**



**Committee met at 7.27 p.m.**

**BARRETT, Mr Patrick Joseph, Auditor-General, Australian National Audit Office**

**CRONIN, Mr Colin Douglas, Executive Director, Performance Audit, Australian National Audit Office**

**HAWLEY, Mr John, Acting Executive Director, Performance Audit, Australian National Audit Office**

**LONG, Ms Tina Therese, Audit Manager, Performance Audit, Australian National Audit Office**

**McPHEE, Mr Ian, Deputy Auditor-General, Australian National Audit Office**

**O'BRIEN, Ms Lynne Maree, Executive Director, Assurance Audit Services, Australian National Audit Office**

**CHAIR**—I call the committee to order and declare open the first public hearing of the Finance and Public Administration References Committee inquiry into the government's information technology outsourcing initiative. I welcome my Senate colleagues and officers from the Australian National Audit Office. On 29 November 2000 the Senate referred this matter to the committee for inquiry and report. The committee has decided to call for public submissions during January and to hold the majority of its public hearings in February and March next year. The committee will be taking into consideration the findings of the Humphry review on IT outsourcing. The committee has requested this briefing on the Auditor-General's report No. 9 of 2000-01, *Implementation of the whole-of-government information technology infrastructure consolidation and outsourcing initiative*. Towards the end of the evening we will move to question the Auditor-General about the current audits, the use of confidentiality provisions in Commonwealth contracts and related legal issues and criteria for considering claims of commercial-in-confidence.

Before we commence, for the record I wish to advise that all witnesses appearing before the committee are protected by parliamentary privilege with respect to evidence provided. I now invite the Auditor-General, Mr Pat Barrett, to make an opening statement.

**Mr Barrett**—Thank you, Mr Chairman. We are in the hands of the committee. We understand that there are specific areas for questions, which we have come equipped to answer to the best of our ability. If we cannot answer the questions this evening, you can be assured that we will get answers to you in the very near future, but, in the light of the questions that are indicated, I expect that we should be able to satisfy the committee's interest.

I did say at our estimates committee the other evening that the reason we have focused in the report on the savings issue was that that was a significant part of the justification for the whole-of-government information technology approach. Adjustments were made to relevant departments' forward estimates to reflect the likely savings that were to be achieved. So, not surprisingly, a good segment of the report does focus on that issue. But I stress, as I did the other day, that we were well aware that the government had other policy reasons for this

approach that has been taken. My simple point was that, to the extent to which we were able to justify the estimates of the level of savings that were to be achieved, we could give some assurance to the parliament of that outcome. We had to be in a position to be able to do that and that is the reason we devoted some time and energy to that issue.

But in relation to the trade-off between that particular advantage and other elements of the justification, we really are not in the position to make any comments about those. But again I stress—I did register this point the other day—that it is recognised around the world that outsourcing in a number of other areas, particularly of information technology, can be justified in terms of achieving better outcomes than would otherwise be obtained by in-house provision. It may come down to issues of scale or issues of expertise and the attraction of relatively scarce expertise. I indicated that my own office had this problem and we do outsource our IT services for that reason. Our own cost-benefit analysis showed that there was almost a lineball relationship between the cost of in-house provision of IT services and what we got back in the most favourable tender. But the pragmatics of it were that we did not have the scale economies; we did not have the critical mass that is needed in a number of these areas to ensure that we could attract the kind of expertise that was needed to maintain this facility. In essence, that is exactly what has happened since we decided to outsource. We wanted to get—as indeed we say to other agencies is good practice—sufficient in-house knowledge, understanding and expertise to be able to properly manage an outsourced contract and to ensure that our IT strategy was oriented towards our business requirements and the outputs and outcomes that the office is meant to achieve.

In this respect it is very important that at least senior management can have this assurance. But I can assure the committee that in our case it has been a very difficult situation in that we have found it difficult to attract even a business manager in this area to oversight our contractual arrangements. It is important in these areas that agencies ensure that they not only have the skills that are necessary to manage the contracts concerned or to manage the tender process and put proper contracts in place but, more particularly, have the knowledge and understanding of the agency's functions and its requirements to achieve its particular outputs and outcomes and the knowledge and understanding essential to be able to get the performance from the IT outsourcing that is warranted and justified in order to ensure that at the end of the day they can be accountable to the government and the parliament for their performance. It is very important—and we stress that—that appropriate knowledge and skills are retained in an agency to properly manage those contracts.

I could go on, but I will simply say that we are on the verge of putting out a better practice guide on contract management which we hope will help agencies in this very difficult area, an area where it is acknowledged that the Australian Public Service perhaps does not have the skill sets that it might otherwise prefer to have, and so help it do something about that, both in terms of buying in consulting services as necessary, or trying to recruit the right people. Another way the better practice guide could assist is by raising the skill levels of people within the agencies themselves. If we can achieve that in a reasonable time frame then I am sure that we will achieve the kinds of outcomes that people see are possible, achieve balanced decisions that are made about outsourcing, ensure that they are complementary to internal resourcing, and achieve the performance requirements that are set down for those agencies and which they have to report on in their annual reports.

**CHAIR**—Unless any of your colleagues want to make any preliminary comments, I think we will move to general discussion.

**Senator LUNDY**—I would like to refer to the work of the Audit Office in the performance audit you conducted on the whole-of-government IT initiative. I know we traversed a few of these issues in the recent estimates hearings, but I want to revisit them, albeit briefly, particularly the overarching issue of the whole-of-government response to this report. You did say at the estimates committee hearing that that was somewhat unusual. I was wondering whether you could advise the committee of your response to the fact that the government chose to deliver a whole-of-government response to your report, rather than allowing each of the agencies, particularly those involved in the relevant clusters that were investigated, the opportunity to respond publicly to the issues you raised.

**Mr Barrett**—As you know, I did say to that committee that the government clearly was entitled, because this was a whole-of-government initiative, to give a whole-of-government response, but equally I made the point that, particularly under the Financial Management Accountability Act 1997, individual agency heads are responsible for the efficient, effective and ethical use of resources. There was not a case of one size fits all here. We do know that these clusters and the arrangements are disparate. I think it would have been instructive in terms of the recommendations, from an audit point of view, if we were able to gain a better view of how the individual agencies regarded those specific recommendations.

I can say to you honestly that this may have influenced the ultimate recommendations we may have made. The section 19 process is a very important process to us. Not only does it ensure that we get the facts right and that our understanding of the issues is reasonable, and the judgments that we are making seem reasonable on the facts of the case, but really the judgments and the interpretation and the views of agencies are equally important in that we can then refine as necessary, or make separate judgments as necessary, as a result. I did say I was disappointed, and I will say that again. We have at least had one other report that I can recall where we have had a whole-of-government response; that is the foreign exchange report. I cannot remember any others. Perhaps my colleagues can.

**Mr Cronin**—We have received a whole-of-government response on the recent report on GBE monitoring, which was tabled last month.

**Mr Barrett**—That is correct. Thanks, Colin. It may well be that, in a number of these reports now, that will be the approach that is taken. I will still be seeking to get individual agency responses but that is up to the agencies and the coordinating agencies concerned in this respect. That is something over which I cannot have any influence. I cannot direct, I cannot control, I can merely ask. But I do think that it is important to the audit process and the outcome of the audit that, if there are variations of views about the impact of recommendations, one way or another, the audit is able to convey that to the parliament. And, as necessary, as I have said to you, we may feel that those reservations or different views are so important that we might decide to put different recommendations forward.

**Senator LUNDY**—Does the fact that it is a whole-of-government response rather than a response from individual agencies and departments affect your ability to follow through to ensure those recommendations were adhered to, as committed in the response to the report?

Again I know it is something we touched on last time but I am trying to discern what issues are confronting you.

**Mr Barrett**—I understand. I did explain the process, but if you are happy enough I will do so again. There is a process that involves the Minister for Finance and Administration, in which the minister regularly gets a report from all ministers as to what action has been taken by the portfolios of those ministers to implement the recommendations of audit reports. In that sense, I would expect that individual agencies would then respond as to what they had done in relation to those particular recommendations, because the portfolio minister has been asked to respond to that. I cannot tell you at this stage, because there has not been one that I have seen, what has happened in that respect.

In terms of our follow-up audit process, we normally do monitor, particularly, recommendations that are important and have important implications for public administration and resource utilisation. If it is felt either that we do not feel that the action being taken is adequate or that it is not being taken in a timely manner—there are other reasons, but they are a couple that I think you could relate to—we would decide to do a follow-up audit. We might get exactly the same reaction, but we would want to then look at the extent to which the individual agencies had implemented the recommendations concerned. So that does open the door somewhat.

Finally, the most important accountability arrangement, in my view, is the quarterly public hearings of the Joint Committee on Public Accounts and Audit. Also, where there is an agreement with other committees, where the joint committee has agreed that another committee might take up one of our audit reports, other committee examinations are done from time to time, and probably increasingly in recent times.

Once that happens, the committee then obviously has the power to ask any agency any question on any matter. I would expect then that individual agencies would have to respond to the JCPAA or another committee about what they have done in relation to audit recommendations or, indeed, in any other related matter to those recommendations. I hope I am giving you a little bit of assurance that the follow-up processes of those three major kinds do allow the parliament to have some ability to look at what agencies have done specifically in relation to audit recommendations or related matters that are of interest in the report.

**Senator LUNDY**—Given that the JCPAA was actually discussed and by virtue of the numbers decided against pursuing issues arising out of this report, does that mean that, for at least the time being, the opportunity for that committee to inquire with individual agencies about their response to this report, or the degree of implementation that they have gone about, is not available in terms of getting that information into parliament?

**Mr Barrett**—My understanding—and this was admittedly from a very recent quick conversation on the run with the chair of the JCPAA—was that he expected that they would have a normal hearing around February.

**Mr McPhee**—Certainly in the new year, yes.



**Mr Barrett**—And earlier rather than later was the impression I got. But I assume that, like you, the committee might take into account the Humphry report. If that report comes out in its scheduled timeframe, then that timing is quite appropriate. The only other issue is whether or not there might be a delay until such time as the government gives its reaction to the Humphry report, and I really have no idea about what that might be. I assume, as usual, it depends on what the report says and how extensive the consultation has got to be. If you want to go into the past, I am sure this committee would recall a number of reports where some time has elapsed between the report actually being produced and the government actually giving a considered view about the report or its recommendations for implementation.

**Senator LUNDY**—Let us just say I am not holding my breath. I would like to go now to the issues contained in the report, but perhaps before I do that I should just explain to the committee that unexpectedly the government has decided to revisit the interactive gambling legislation, which I am required to handle on behalf of the opposition. I just want to flag now that I might be suddenly called away, in which case my colleagues will obviously continue to ask questions.

**CHAIR**—I think there are enough ball carriers here.

**Senator LUNDY**—I am sure there are, but I just wanted to provide that explanation.

**Senator CONROY**—Mr Barrett, you said you have to convey your reports to parliament and you talked about how you may have made different recommendations if there had not been a whole-of-government response. I think that is what you said.

**Mr Barrett**—I said there was a possibility that, depending on what the individual agency's comments might be, we may have decided to have varied the recommendations. We might have decided to have specific recommendations that related to specific clusters, for instance. On the basis that on the face of it there is no one size fits all, I think most private and public sector people would agree that, while in principle a lot of these issues would be shared, the practice in a number of cases depends on the nature, the extent, the history and the direction that the particular group is going in.

**Senator CONROY**—So you are saying that a universal template—do it this way—is not necessarily appropriate.

**Mr Barrett**—I think that would be generally accepted. Unless they are at a very high level—and if you look at these recommendations a number of them are at a reasonably high level—the recommendations could have been more specific. That is what I suggest.

**CHAIR**—On that issue, and in a more general sense, we have just completed an inquiry into one aspect of APS employment. That had to do with AWS, as you are aware. Main features of a lot of the evidence that we were given were the devolved environment that was occurring and the devolution of power into the individual agencies and decision making at that level. If there is not going to be a consistency of approach in respect of the government across issues, does that not raise some considerable concerns? Doesn't it raise some concerns that we are dealing with some issues on a devolved approach, some issues on a whole-of-government approach and some issues on half a whole-of-government approach and a devolved approach? Where do you

get some consistency in the way in which you get public accountability if it is open to making a judgment on how you will deal with an issue dependent on what best suits the circumstances?

**Mr Barrett**—You do not need me to tell you that you have hit on one of the major dilemmas in present public administration. Indeed, there are fairly compelling arguments in which we have already witnessed shared outputs and shared outcomes where there clearly needs to be some agreement, particularly between those who are responsible as well as on the specific outputs and outcomes that the individual agencies are responsible for. In this case, the government has made a whole-of-government decision which it has asked the relevant heads of agencies to put in place. At the end of the day a number of policy objectives had to be met, of which one, I assume, still remains, and that was a cost effective production of outputs and outcomes. There are clearly tensions there—I do not need to explain to this committee that there are tensions there—and it really is a matter, as it is always in public administration, of striking an appropriate balance. All I am suggesting to you is that, while the point you make is quite valid, that balance may vary in the application—not the policy, the application of the policy—depending on the nature and the circumstances of the agencies and the outputs and outcomes that they are responsible for.

**CHAIR**—That was a point that struck us in the previous inquiry, but it also seemed that what was not taken into account, either in a devolved environment or in a whole-of-government approach, was that there was a difference between individual agencies and circumstances. As a consequence, the application of whatever policy adopted had to have a different impact upon each of those agencies depending on those individual circumstances.

**Mr Barrett**—Also, I would think that in such circumstances there does need to be some coordinating arrangement to ensure that such inconsistency is taken into account and met by the approach that is taken by individual agencies. In other words, if for their own accountability and their performance they take particular decisions which may impact adversely on, or not be conducive to meeting the broader policy requirements, then there has to be some body, some arrangement in place that indicates that that trade-off is not the appropriate one and that the agency concerned should be giving more consideration, perhaps, to the broader policy issues than it appears to be doing in the narrower context or vice versa.

I am simply saying that, in a devolved environment where agency heads, under the Financial Management and Accountability Act, are clearly personally responsible for efficient, effective and ethical use of resources, there have to be clear government decisions that they can point to where they have got any contradictions or inconsistencies between a specific approach they may take in relation to the particular circumstances of the agency, or in relationship to the overall policy. There is always a dilemma there. All I am saying is that you would think there has to be some organisation or someone that actually puts their hand up and says, ‘Hey, this balance is wrong.’

**Senator BUCKLAND**—Mr Barrett, getting that consistency does seem to be an overriding factor in this. Where are those broad guidelines to give us some indication? Accept that I may not have read that; I have not been here that long, so I ask you to bear with me. Where are those broad guidelines, and how far from those can the individual agency heads stray?

**Mr Barrett**—There are guidelines for individual activities. For instance, there are procurement guidelines. There is guidance in terms of the approach that we should be taking to implement public service values, codes of conduct and the like. I do not think there are any guidelines that tell managers how to manage. At the end of the day, that is their responsibility and that is what they get paid for. But, so long as the directions and the decisions are clear, it is then up to the individual manager to manage in accordance with those directions or decisions. There is no guidance to say to them what balance they can strike. That is the nature of the management function. At the end of the day they will be held accountable for the outcomes, or lack of outcomes, they achieve.

**Senator LUNDY**—Going back to the issue of whole-of-government recommendations: at what point were you advised by the department of finance that you would be receiving whole-of-government responses to your recommendations? For example, was it after you had prepared agency specific recommendations, or before? What was the timing of that?

**Mr Barrett**—I cannot recall the date but Mr Cronin may remember it.

**Mr Cronin**—It was during the section 19 period. Prior to this we had prepared issues papers in December 1999 and we subsequently prepared the discussion paper which contains our draft recommendations. That went out in May 2000, which led through to our—

**Senator CONROY**—Went out to whom?

**Mr Cronin**—It went out to all the individual agencies involved.

**Senator LUNDY**—So you actually prepared recommendations on an agency specific basis?

**Mr Cronin**—Yes, we prepare the recommendations. The major agency involved in this was OASITO, and then you have the ones relating specifically to the contract management issues, which are really in chapters 8 and 9. But prior to that the majority of the report, essentially chapters 2 through to 8, concern, essentially, OASITO because it relates to the implementation of the IT initiative, both in terms of the cluster tender arrangement and in terms of their engagement of consultants.

**Mr Barrett**—Just to follow up on that, the only point that was made in relation to the question that you proffered earlier was that, if this were to be a general approach, what would the likely impact be. Quite clearly, the approach I would still suggest is as I indicated: that, if we do not have any reason to vary the recommendations, because of the whole-of-government approach, then we would think they are appropriate. But I am not giving you any guarantee that, if individual agencies have not responded—because that is the whole section 19 process—to say that they are not actually applicable to their circumstances, that might lead us to again look at maybe splitting a recommendation or making a specific recommendation in relation to a particular cluster, for instance.

**Senator LUNDY**—Just to clarify that: through that section 19 process, in developing your recommendations, they are then provided to the agencies involved and feedback is gathered from the individual agencies?

**Mr Cronin**—Section 19 is the statutory period in which the Auditor-General has to issue the report for agencies, and they have 28 days to comment. So it is the draft report and they are the recommendations, as structured. Prior to that, in a discussion paper period that went through from May until late July, we drafted the recommendations in considerable detail and issued them to the departments. Each of the departments received the report, and then we received a whole-of-government response that incorporated most agencies—not all the ones we issued a section 19 to.

**Senator CONROY**—Did all of the recommendations appear in your final report, or did you have to change some of them because you then received a whole-of-government response?

**Mr Cronin**—There was very little change in the recommendations. There can be wording changes within the recommendations but, as such, the response we received constituted two parts: a commentary, which is included under each of the recommendations; and an overview from DOFA. The flavour of that is actually picked up in the report's introduction, in paragraph 46 on page 27, which is the nature of their general comments. On top of that, we get some minor factual material or textual changes. They tend to be the three components.

**Senator CONROY**—If I can just get this clear in my head: you have the section 19; you have done a preliminary assessment at this stage; you make some recommendations; you put it to the agency for comment; in other circumstances, with other audits that you have done, they respond to you directly; and you then make further refinements in the light of their answers?

**Mr Barrett**—Yes, we may change the recommendations in the light of the comments made. It would not be the first time. We may in fact strike out particular recommendations.

**Senator CONROY**—They may satisfy you of the—

**Mr Barrett**—That is exactly right. That is how important the section 19 process really is. Of course there are natural justice concerns in that too.

**Senator CONROY**—Sure.

**Mr Barrett**—But really it is a matter of establishing that we have the facts and our judgments are appropriately based. Unfortunately, there are circumstances where agencies perhaps do not respond as fully as they should to the issues papers, and they respond to the section 19. Not surprisingly, if they do that then it could have a marked impact on where we come out.

**Senator CONROY**—Unfortunately, I have never covered off on one of your audits before, so you will have to bear with me. You send it out to all the agencies and, instead of their responding to you individually, you then get this DOFA document back, or whole-of-government response?

**Mr Barrett**—There were a couple of specific comments which I think are on page 26. But unless my colleague tells me something different, I do not think we really had any great comment from individual agencies on any of the aspects of the report.

**Mr Cronin**—There were some comments, such as from Defence, on an individual recommendation.

**Mr Barrett**—Those are the ones I am referring to

**Senator CONROY**—So you still did receive some communication back from individual agencies? For example, you are in conversation, effectively, with all the agencies and then suddenly out of the blue you get the whole-of-government response or they phone you and tell you, ‘By the way ...’?

**Mr Cronin**—Yes, that is correct.

**Senator CONROY**—So you just received the one response. At this point, who were you then in a position to hold a discussion with?

**Mr Cronin**—We held the discussion with the Department of Finance and Administration.

**Senator CONROY**—You were not then able, because of the manner in which the government responded, to go back to the agencies to have individual discussions?

**Mr Cronin**—DOFA handled all the discussion. There were changes in the report in terms of recommendations being agreed, with qualifications being changed to ‘agrees’ et cetera, so there was movement. But at all times DOFA handled all of that and their coordination with the agencies.

**Senator CONROY**—In effect, what I am saying is that there was then a tier put in place between you and the people that you had been dealing with previously.

**Mr Cronin**—That is correct.

**Senator LUNDY**—By the department of finance?

**Senator CONROY**—It was DOFA. DOFA put themselves in between you and the agencies, effectively, by this mechanism.

**Mr Cronin**—They had agreed with the departments to provide the single response.

**Senator LUNDY**—Going to page 26, I want to quote from paragraph 44 of the report. It says that DEWRSB commented that it supports in principle the recommendations of the audit report. Can you tell me whether that extended to the financial methodologies used by the Audit Office to calculate the respective savings?

**Mr Cronin**—That was a general comment. They did not go into the specifics.

**Senator CONROY**—On this question of the calculations, I do not know whether you really lack bedtime reading or whether you have had a chance to see the *Hansard* transcripts of Senate estimates involving DOFA.

**Senator LUNDY**—OASITO.

**Senator CONROY**—Has anyone had the misfortune to be asked to have a look at that?

**Mr Cronin**—We have read those.

**Senator CONROY**—Commiserations. You would be aware there was a lively debate about the method of calculating the costings. DOFA have introduced accrual accounting right across the Public Service.

**Mr Cronin**—That is correct.

**Senator CONROY**—But OASITO told us that they are still operating on a cash basis.

**Mr Cronin**—Yes, that is correct.

**Senator CONROY**—Are there any other agencies you have encountered that are still on a cash basis?

**Mr Cronin**—No, not that I am aware of.

**Senator CONROY**—Is that a no?

**Mr Barrett**—As far as I am concerned, we are all on accrual accounting, accrual budgeting.

**Senator LUNDY**—Does the department of finance's methodology in calculating savings under this program represent the only example you know of where the government still uses a cash based accounting methodology?

**Mr McPhee**—Even with the move to accrual accounting, it is important not to ignore the cash as well. So accrual accounting is intended to—

**Senator LUNDY**—That was not my question.

**Senator CONROY**—Equally, it is important not to ignore totally the accrual application.

**Mr McPhee**—Absolutely. I was just trying to give a balanced response to the question, but I agree with you.

**Senator LUNDY**—So there is not any other?

**Senator CONROY**—They are dismissing the accrual processes in which you have come to your positions. They just dismiss it out of hand. I am sure, Mr Cronin, you have read that.

**Mr Cronin**—Yes.

**Senator CONROY**—Does it surprise you that they just dismiss out of hand the accrual process?

**Mr Cronin**—Yes, but the concept we applied, which has been a process which has been consistently applied in the Commonwealth Public Service for over 30 years, is discounted cash flow analysis. This has got a long generic credence in terms of IT. In fact, in 1993, the department of finance put out a publication titled *Value for your IT dollar*, of which we can provide you with a copy, which superseded a public service board guide to cost effectiveness analysis of ADP systems, which goes back to 1981. So we will provide the secretary with it.

**Senator CONROY**—What did you call it—a guideline or a practice note?

**Mr Cronin**—It was a guide to cost effectiveness analysis of ADP systems. The issue that comes up here is the determination of the most effective use of Commonwealth resources. The issue we have with OASITO relates to the measurement of cash, but where we come apart is on the question of residual values on assets.

**Mr Barrett**—I would ask Mr Cronin to read out the relevant section on the residual value, which the committee may find of interest.

**Mr Cronin**—There are two component parts in here. The 1993 report of the Department of Finance, in paragraph 9.14, on page 52, notes that if assets were purchased there may be a residual value at the end of the analysis. This residual value must be accounted for in the cash flow or the purchase option. It then takes you back to an example given in paragraph 4.7, which talks about an example of printers. It says that at the end of the analysis period the value of the printers should be included in the analysis as a benefit. That captures essentially the economic outcome of your analysis: your cash flows in and out and the residual or terminal value of the assets. We would see that as having precedent in the Public Service.

**Senator CONROY**—That is a DOFA document?

**Mr Cronin**—That is a DOFA document. We can give you the Finance circular issued in 1993, which gave credence to that document replacing the previous Public Service Board document.

**Senator CONROY**—So that became the standard practice operating procedure. Is that a fair characterisation? If there is a better characterisation I am happy to hear it. Mr McPhee is nodding. Is there a better way to express it than I just did?

**Mr McPhee**—It accords with standard analysis. What we are proposing I do not think is anything very innovative. As Mr Cronin mentioned, this approach has been around for a very long time, and supported by the earlier Finance publications, which is entirely consistent with the analysis we adopted in our report.

**Senator CONROY**—You might have noticed that there seemed to be some confusion about the status of OASITO in its relationship with the finance department. I always thought it was part of the finance department, but there seems to have been some confusion there. In your opinion, what is the status of OASITO?

**Mr Barrett**—I do not think we are qualified to comment on that.

**Senator CONROY**—It is not an independent statutory authority?

**Mr Barrett**—Let me just say that it was established as a separate office and it has a secretary equivalent. So in that sense it is an agency.

**Senator CONROY**—Are agencies in general bound by the finance department guidelines?

**Mr Barrett**—I would have thought we all are.

**Senator CONROY**—A whole-of-government approach, I would have thought, is possibly a way to describe it.

**Mr Barrett**—Particularly in relation to the chairman's question earlier: all of us are looking for whatever guidance is around to help us make decisions. For years, authoritative guidance did come out of the previous Public Service Board—now the Public Service and Merit Protection Commission—and the Department of Finance, now the Department of Finance and Administration. It would not be surprising that all agencies would be looking to see where the official guidance came from, in order to get at least some approach that they could take with some confidence.

**Senator CONROY**—Do OASITO cite to you any alternative guidelines, notes or procedures that they believe overrides that and entitles them to account for the values in the way that they do—in other words, ignoring the residual value?

**Mr Cronin**—We have had a long-running dialogue with OASITO over this matter. You should be aware that their methodology has undergone a number of changes.

**Senator LUNDY**—I was going to come to that.

**Senator CONROY**—Can they point to a guideline, practice notes, an official edict that allows them to be outside of the finance department's guidelines?

**Mr Cronin**—They point to expert advice which was received after the completion of these tenders and relates to their continuing changing in methodology, but no, we have not been able to come to a meeting of the minds on terminal values.

**Senator CONROY**—Expert advice from whom?

**Mr Cronin**—They have a number of consultants that they sought advice from. They also had their strategic adviser prepare guidelines for the financial analysis.

**Senator CONROY**—What sort of consultant are we talking about? Are we talking about an actuary, an accountant, a lawyer, mickey mouse?

**Mr Cronin**—Their initial guidelines, which were prepared in October 1998, I think are attributed to their strategic adviser, Shaw Pitman.



**Senator CONROY**—I do not know who they are. Are they a legal firm or an accounting firm?

**Mr Cronin**—They are employed at OASITO as a strategic adviser. We understand they are a major US law firm.

**Senator CONROY**—So they would be familiar with the Department of Finance and Administration?

**Mr Cronin**—I cannot answer that.

**Senator CONROY**—I'm joking. Are you aware which method is used in America? Is there an American practice they are applying to our quaint ideas?

**Mr Cronin**—We are not aware of that.

**Senator CONROY**—Is there an international standard? Are we based on the international standard?

**Mr Cronin**—We believe our methodology in terms of the treatment of end of term assets of agencies accords with general corporate finance principles.

**Senator CONROY**—I know there is a difference in world accounting standards between GAAP and the European models.

**Mr Cronin**—We do not see it as relating to an accounting issue, we see it as relating to a matter of corporate finance and how you would go about analysing a new investment. You do not need to be an accountant, you can be a corporate analyst. It is the notion that people will seek to optimise their financial outcome, and the inclusion of that value of terminal assets can be a significant component of any analysis.

**CHAIR**—Are you familiar with what would happen in the private sector?

**Mr Cronin**—Yes, we believe that this approach mirrors what happens in the private and public sector.

**Senator CONROY**—They do not often value their assets to zero, do they?

**CHAIR**—Is that a consistent approach in the private sector?

**Mr Cronin**—We believe that at the end of doing an analysis of an investment option, a private firm, as the government would do, would consider the cash flows during the life of the evaluation period and the terminal values of assets at the end—that is, they have service potential outside the evaluation period.

**Senator CONROY**—Do you think shareholders in a company would accept a zero value on a residual if it was presented in a set of accounts?

**Mr Cronin**—No, Senator.

**Mr Barrett**—I might ask Ms O'Brien to respond here, but clearly the general mood as I detect it in the profession would be to have these kinds of things exposed on the balance sheet. The way in which the standard is moving, as far as I am aware, is to have greater transparency.

**Ms O'Brien**—There is an international discussion paper on accounting for leases currently under exposure in Australia. As the Auditor-General has indicated, it does make recommendations in relation to greater disclosure in relation to these types of arrangements in financial statements reporting.

**Senator LUNDY**—How does that issue relate to the difference between operational and finance leases as described in the Audit Office report?

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

**Senator LUNDY**—But the Department of Finance and Administration has rejected that, saying that they perceive these leases as operational leases.

**Ms O'Brien**—The Australian accounting standard currently requires that leases be categorised as either operating leases or finance leases, and the Department of Finance and Administration has reached a view that these leases should be treated as operating leases.

**Senator CONROY**—How do you view them?

**Ms O'Brien**—We view them as finance leases. Our interpretation is that the majority of risks and benefits of asset ownership under these arrangements sit with the Commonwealth agencies, and that is the definition of a finance lease under the standard.

**Mr Barrett**—In particular cases. There are some that we accept that are operating leases and we have treated them that way in our audits this year.

**Ms O'Brien**—That is right, yes.

**Senator LUNDY**—Just to clarify this, this is another point of distinction between yourself and the Department of Finance and Administration. They are arguing that what you consider to be finance leases are operating leases, are they?

**Ms O'Brien**—Yes.

**Senator LUNDY**—What are the implications, in terms of the residual assets of agencies, of that argument being pursued by the Department of Finance and Administration?

**Mr Barrett**—Probably Taxation is the best example. My two colleagues on my left can give you some figures on that but obviously they, because of their residual values, are quite significant because their IT expenditure is quite significant.

**Mr Cronin**—In terms of the savings, because there is a residual value in there which the Commonwealth is exposed to, in the ANAO's analysis we counted this in the offsets to the savings. If it had been an operating lease we would not have counted it, and the reason we counted it, as Ms O'Brien pointed out, was because the Commonwealth bears the decline in the residual value at the end of the period below net book value. The loss of service capacity and obsolescence of these assets at the end of the period resides with the Commonwealth, so we saw the economic substance of the risk transaction as being with the Commonwealth. Accordingly, we incorporate into our evaluation a value for these assets. As we said, if they had been operating leases, the Commonwealth would not have had that exposure and hence would not have been incorporated into the analysis.

**Senator CONROY**—Is that because they would have leased somebody else's asset rather than having their own?

**Mr Cronin**—Yes. We would not have had an exposure at the end of the five-year period. So we are up for, essentially, a balloon payment at the end of this period.

**Senator LUNDY**—Yes. To clarify that, had those assets not been in the possession of the agency or department at the beginning of the contract and those assets been sourced somewhere else and therefore accounted for in a different way, that situation would not arise where the Commonwealth would be exposed?

**Mr Cronin**—Yes. The Commonwealth has been exposed because of the nature of the contractual agreement and when the Cluster 3 analysis was done, OASITO's initial guidelines actually included, as an offset against outsourcing, the cost of the end of term vendor assets.

**Senator CONROY**—So they actually incorporated it at the beginning.

**Mr Cronin**—Yes, in the analysis. We would say that they actually overcompensated because they included the full value, while we only include the value between the fair market and the net book value, so ours is a lower quotient. In the Cluster 3 analysis there—

**Senator CONROY**—You would not have a copy of the original analysis they did, would you?

**Ms Long**—In figure 1 in the summary of the report, you can see the effect of our adjustment for cluster 3, and the net effect is quite minimal because we have assumed 50 per cent fair market value of book value on both sides, so by the time we have done both of our adjustments, it comes very close to the total book value adjustment that was made originally.

**Senator CONROY**—So you are saying their original and your final were about the same.

**Ms Long**—There was a movement of something like \$1.2 million over the savings that had been identified. This is the financial savings of about \$62 million originally.

**Senator CONROY**—Do they give you any explanation for changing their methodology at that point?

**Mr Cronin**—We have confirmation that on 22 March 1999 they formally put in writing their changes in their methodology. This was the date at which the Group 5 preferred tender evaluation was completed.

**Senator CONROY**—You confirmed that they put it in writing?

**Mr Cronin**—Yes.

**Senator CONROY**—What was their reasoning for this change in methodology other than the obvious—that the numbers unfortunately no longer added up as well as they had hoped?

**Ms Long**—The rationale, as far as I understand it, was related to the Prime Minister's letter of 22 December.

**Senator CONROY**—I was going to come to that.

**Ms Long**—The evaluation methodology was looked at in light of that policy clarification and it was considered that in the cash flow analysis that they had been doing that in fact including the net book value at the end either to repurchase the assets to bring it back in-house or on-sell to another vendor—

**Senator CONROY**—That is a very complicated letter from the Prime Minister. He displays skills as a lawyer that I did not realise he had.

**Ms Long**—The view was that that then became far too conservative an approach and was not appropriate, given that the policy was that the agencies would remain outsourced. Therefore, there would be no repurchase of assets and, therefore, it should not be included in the analysis. That is the rationale as I understand it.

**Senator CONROY**—No repurchase? The Commonwealth owned them.

**Senator LUNDY**—I just want to clarify the significance of the Prime Minister's letter. Was it dated December 1998?

**Ms Long**—Correct.

**Senator LUNDY**—You are saying you received written confirmation of the change in financial methodology on 22 March?

**Ms Long**—It was not written confirmation to us. It was the formal notification to the Group 5 Steering Committee that OASITO required the change in the evaluation methodology.

**Senator LUNDY**—And you have identified that in your report. Can you refer me to the pages in the report where that is detailed? I have read it somewhere.

**Mr Cronin**—It is in terms of two things: there is paragraphs 7.50 to 7.60, which is pages 168 to 171, and also paragraphs 7.28 to 7.29.

**Senator LUNDY**—Just on that point: the major implication in the letter from the Prime Minister, as I understand it, was that the business case that had to be established for outsourcing was now to be on a whole-of-government basis. That is, it should proceed unless there is a reason for everyone not to do it. And that letter, you are saying, was used as part of your audit analysis as some justification for a modification of the financial methodology?

**Mr Cronin**—We might take you to page 121, footnote 123—sorry to go into the footnotes—where you would notice that the last sentence says:

As at December 1998, savings had not been identified against any of the Group 5 tenders.

**Senator CONROY**—I presume you have seen the Prime Minister's letter—I have not; I have only read some of the extracts which you have included. Does anything in that lead you to have the view that they were no longer finance leases but were in actual fact operating leases?

**Mr Cronin**—No, nothing in this. This relates to the notion of whether you should nor should not outsource on a whole-of-government basis.

**Senator LUNDY**—It seems to me that what this footnote says is that OASITO used this letter from the Prime Minister as justification to proceed with Group 5, despite savings not having been pre-identified with the signing of the services agreement. Is that the case?

**Mr Cronin**—That is essentially what the footnote and the text refer to, as at that point of December 1998.

**Senator CONROY**—I accept that there is an edict which came through from the Prime Minister saying, 'Look, it does not matter'—as Senator Lundy has pointed out—that there is a cost saving involved.' But I am trying to understand how that affects whether or not something has a zero value as a residual or as a finance or operational lease. That I am still confused about.

**Mr Cronin**—I think in a sense they are separate components. The first thing is to do the analysis to determine whether there are savings or not. As we go through Group 5, on the ANAO's analysis we show there are not financial savings. On the Cluster 3, the analysis shows clearly there are significant financial savings.

**Senator LUNDY**—From what you have told us, with Group 5 only being formally advised of the change in methodology some three months later, at the time of the signing of that agreement OASITO would have been using their original methodology, and they would have known that there were no savings to be found at that time of signing.

**Mr Cronin**—The point at which OASITO finds savings is certainly some time in early 1999.

**Senator LUNDY**—So, after the contract had been signed?

**Mr Cronin**—The contract was not signed until further in 1999.

**Senator LUNDY**—But it had been announced in December?

**Ms Long**—No. The preferred tenderer for Group 5 was identified in late March and the contract was signed in the middle of April 1999.

**Senator CONROY**—Their early analysis was done in December, did you say?

**Ms Long**—They were in tender evaluation at that time. The bids had closed and evaluation had commenced and had been ongoing.

**Senator LUNDY**—So at least from OASITO's evaluation perspective, they had done their analysis and had not found any savings?

**Mr Cronin**—Group 5 is a very complex one because it goes through a number of rebids. It is quite late in the piece that savings arise. If you go to figure 5.1, you will see the details, which appear on page 105. The tenders for Group 5 actually closed in August 1998 and the final evaluation report was not completed until 22 March 1999. It is seven months later, so there is a long period before the savings become evident.

**Senator LUNDY**—I remember at the time that delay was quite inexplicable.

**Senator CONROY**—Not any more.

**Senator LUNDY**—Yes, it is very explicable now. I do not know whether it is appropriate to ask you this, but it seems to me that if the government was aware that savings were not being found in the Group 5 contract, and they would have known that at that point in time in terms of the tender evaluation, that indeed had some role in prompting the government to make the policy response that was embodied in the Prime Minister's letter of December 1998.

**Mr Barrett**—I do not think we can really comment on that, Senator. I think you would understand. We are not in a position to know. We can only give you the facts of the situation as we see them and the time and the dates.

**Senator LUNDY**—Just on a factual point then: if it articulates this in this report, when would be the earliest point that OASITO would have been aware of the savings outcomes under their original methodology for the Group 5 contract?

**Mr Cronin**—I cannot answer that, Senator.

**Senator CONROY**—Maybe it is easier this way: the close of tender was 1998, did you say?

**Mr Cronin**—For Group 5, I believe it was 6 August 1998.

**Senator CONROY**—They were then conducting their analysis and I thought you were saying that in December they had reached this view that, using this evaluation method, there were no savings. That was in December 1999?

**Mr Cronin**—No, December 1998.

**Senator CONROY**—You couldn't put an exact date on it but you were aware from looking at their documentation that, some time in December, they had come to the conclusion, under what could be described as a jointly agreed evaluation method, or jointly used—

**Ms Long**—In fairness, there were some issues going on that contributed to the length of the Group 5 tender.

**Senator CONROY**—I am not being critical there. I am just trying to—

**Ms Long**—There were some administrative arrangement changes that involved agencies within the tender and that delayed things somewhat. The other major factor was that there was ongoing discussion between OASITO and the agencies involved in the tender as to the cost baselines that had been established for the agencies as to whether they fully reflected the service levels that tenderers were being asked to bid for. There were a number of reviews of the agency baselines and, as Mr Cronin said, a number of rebids by the tenderers.

**Senator CONROY**—I am not being critical of the length of time. I appreciate that, as you said, it was a very complex one. Some time in December 1998 you were aware that under that evaluation method they had looked at it and thought, 'No cost savings here.' So that was in the December period. I am not asking for an exact date, but it was around then.

**Mr Cronin**—What we can say is that, under their financial guidelines, at that stage no savings were being derived for Group 5.

**Senator CONROY**—When did the Prime Minister write his letter?

**Mr Cronin**—It was on 22 December 1998.

**Senator CONROY**—That was a busy Christmas in 1998. They announced the tender in March 1999?

**Ms Long**—In March.

**Senator LUNDY**—What date in March?

**Mr Cronin**—The 22nd.

**Senator LUNDY**—The same day that Group 5 was advised by OASITO of the formal changes in methodology? You gave that date of 22 March earlier.

**Mr Cronin**—We have written confirmation in terms of the guidelines for financial adjustments and we have it dated 22 March 1999, which picks up that change to the treatment of vendor assets.

**Senator LUNDY**—That was dated the same day that the Group 5 tender was announced?

**Mr Cronin**—And I believe there was direct correspondence with the Group 5 evaluation committee on that date.

**Ms Long**—There had been discussions obviously—

**Senator CONROY**—Beforehand? They would not just say, ‘Hi, you’re signing today and, by the way, we’ve changed the valuation method.’ This mob might have, but even I think that is unlikely.

**Ms Long**—That is right, there had been discussions with both the ATO and with the Group 5 agencies, the two evaluation tenders in train at the time, and both the ATO and the Group 5 agencies registered some disagreement with the change.

**Senator LUNDY**—Hang on, let’s get this clear. Leading up to the very final stages of negotiation of the Group 5 contract, there was still disagreement between agencies and OASITO about the financial methodologies, and then on the day of signing. So prior to that agreement perhaps being resolved—and we can only speculate about that—OASITO also delivered in writing to the Group 5 agencies their decision to change the financial methodologies. Is that a fair reflection of what occurred?

**Ms Long**—I think that is fair. The resolution of the issue is not clear to us, based on what we have seen. We do note in the report that the ATO noted in the evaluation report that they in fact did still disagree with that—

**Senator CONROY**—The ATO would be using the department of finance’s guidelines, I would have thought, as their guiding principle. Is that a fair comment?

**Mr Cronin**—The agencies have a role in this approach, but the actual implementation rests with OASITO, so it is essentially with OASITO and its advisers, and the methodology is essentially given to the agencies. If you go to paragraph 7.52—

**CHAIR**—When you say ‘OASITO and their advisers’ are you specifically referring to Shaw Pitman?

**Mr Cronin**—Shaw Pitman amongst others. Each of the advisers has various roles. Obviously the strategic adviser has a very key role, as noted by the quantum of the funds, and their ongoing role with OASITO and its predecessor throughout the initiative. In paragraph 7.52, on page 169, you will note that the Group 5 evaluation committee requested a copy of OASITO’s expert advice for the change in the treatment of end of term vendor assets. ANAO were advised that their advice was verbal only for this major change.



**Senator CONROY**—Verbal? So no-one has ever seen it in writing?

**Senator LUNDY**—How many millions of dollars is this advice worth to the agencies?

**Mr Cronin**—Written advice was not provided to OASITO by its expert advisers until 5 July 1999, which is some months after the execution of the contract.

**Senator LUNDY**—OASITO provided advice on 22 March but had based on that advice on verbal advice from Shaw Pitman?

**Mr Cronin**—It is not our understanding that the advice would necessarily involve Shaw Pitman.

**Senator CONROY**—Do you know who the verbal advice came from?

**Mr Cronin**—They also used accounting advisers.

**Senator CONROY**—Any idea who?

**Mr Cronin**—A number of major accounting firms.

**Senator CONROY**—They just shopped around a bit, did they?

**Mr Cronin**—They generally used two firms.

**Senator CONROY**—Who were?

**Mr Cronin**—PricewaterhouseCoopers and Deloittes.

**CHAIR**—Is it normal practice across the Public Service to just accept verbal advice on something of such a significant nature as this?

**Mr Barrett**—It depends. I can only speak to you from experience. Obviously, if it is an urgent matter and you need to get advice quickly, then you will proceed on verbal advice, but you always ask for it to be followed up by written advice. If you had your druthers, you would say, 'Please give me at least an indication by fax or something,' and then follow it up with the full advice later if it was urgent. But I think that it would be generally accepted in the public service that, where there is an important issue on which you are going to rely on giving guidance, you would seek to get written advice to use.

**Senator CONROY**—When OASITO decided it wanted to change the method of evaluation, did it have to get agreement from the agencies that it was negotiating on behalf of? Do they have to get Tax to sign off on this?

**Mr Cronin**—We might deal with the tax issue. You can see that there are some references in the report to this.

**Senator CONROY**—I did not mean in terms of the actual tax treatment. I am happy to come to the tax treatment.

**Mr Cronin**—So we are talking about the ATO.

**Senator CONROY**—The ATO, yes.

**Ms Long**—In fact, in paragraph 7.51, we have actually quoted the comment by the ATO in the final evaluation report, in which they are registering that they believe that that adjustment—

**Senator CONROY**—Was wrong.

**Ms Long**—That the adjustment that was originally in the guidelines was included to provide a normalised costing.

**Senator CONROY**—Yes. So they still considered they owned the asset and believed it had value.

**Ms Long**—The point that they were making was that their cost baseline—as in the ‘business as usual, keep it in-house case’—included the purchase of assets which had service potential further on from the evaluation period. In the outsource case, they would be leasing assets. Once that period finished, you did not necessarily have access to the assets. So you have made an investment and you should identify that there is that ongoing service potential in the evaluation. The adjustment that was being made in the guidelines originally was associated with an assumption about buying back the vendor’s assets but, as we showed with our evaluation, that gave a de facto recognition of the terminal assets on the agency side.

**Senator CONROY**—Thank you for that. I tragically have only done first-year accounting.

**CHAIR**—Are you saying that to get a residual value of zero, where there is outsourcing taking place, there would have to be a payment up-front for the assessed value of the asset at that point in time that it is outsourced?

**Ms Long**—There are two sides to the evaluation, and the issue of the agency assets that they would own at the end of the evaluation period if they continued is completely separate from the notion of selling the agency assets to the vendor at the start of an outsourcing. They are two issues that are running parallel and you compare the two to get the savings analysis. So the payment for assets happens on the outsourcing side, and the vendors in their bid offer a value for the existing agency assets. They are then transferred over and the ownership goes to the vendor. On the side—where you are looking at: what do we do if we just keep it in-house?—you may be periodically spending on refreshing your assets so that you have got assets at the end of the year five which you intend to continue using for, say, another two years. So even though you have outlaid the cash and it is picked up in the cash flow that is looked at in terms of comparing the costs, by not including that ongoing service potential you are making leasing look much cheaper than the buy option in the two different parallel cases.

**Mr Barrett**—To put it simply, if you are faced with a contractual situation, either you pay or agree to take the liability. Therefore, the leasing charge should be lower or the tenderer says, ‘We will look after it for you,’ that the leasing charge would be higher.

**Senator CONROY**—You summed that up well.

**Mr Barrett**—It is no small matter. There has been comment and speculation that this is not really important, that it is a storm in a teacup, so to speak. But I think the point that has been made is that, particularly when there are significant assets such as personal computers, for instance—say, 30,000 of them—if you have got a leasing charge there that goes beyond the period of the contract and you have still got the responsibility for it, it is not a small amount. The same thing would apply in terms of the assets themselves. A comment has been made that in the normal course of events they would have no value at the end of the contract. That may fortuitously be the case but, as in the example I gave to the estimates committee the other day, if in the normal course of events you replaced your PCs every three years and you had a five-year contract, and if you started off at three years and replaced them in the fourth year, so to speak, then from a balance sheet perspective you would have a pretty significant asset still on the balance sheet in the fifth year. Admittedly, though, if you actually had to go to the market and sell them, they would not be worth much, so you would take a not insignificant hit. Is that fair comment, my colleagues? So it is not a trifling matter. It can be in some circumstances.

While I have got the floor, if you do not mind, Mr Chairman, I would simply make the point that I understand why the senators are asking the questions but at the end of the day I had to make a professional judgment, informed by the best advice that I could get. That is what the parliament would expect of me and certainly that is what the profession would expect of me. We do know that there are differences of views in particular circumstances, but at the end of the day it was not a question of the treatment per se and the impact of the treatment. It was really a simple fact as to what kind of lease this was. We said in particular situations that there was a liability there and it had to be taken into account. We took a fairly conservative view, as Mr Cronin said, about the valuation, and indeed I think the interest rate could be said to be realistic and not anything outrageous.

**Senator CONROY**—This is the one you used for the discounted cash flow?

**Mr Barrett**—Yes. In that sense I think it was—

**Senator CONROY**—What figure did you use?

**CHAIR**—Just let Mr Barrett finish.

**Mr Barrett**—Having made those sorts of judgments as required, and the figures that were eventually suggested, I think under any normal circumstances in which the parliament would take interest in this matter is not an insignificant issue. So what I am saying is that it is not just a debating point that we are talking about here. There is a professional judgment that has been made and, in fact, in our opinion there are very real dollars involved. If these are significant in terms of decision making, then they should be taken into account. The view that I offered the estimates committee the other night was that normally there are, as I indicated earlier, other reasons for doing outsourcing. But if savings is an important reason and they are not achieved

for whatever reason—legitimate mistakes, misjudgments and the like—then that throws the balance, from a management perspective at least, on justifying what you have done on whatever other reasons that you have had for outsourcing. So that balance is quite important at the end of the day, particularly if it is instructive for yet another arrangement in the future because, hopefully, you learn from experience.

**Senator CONROY**—What interest rate did you use, just out of interest?

**Mr Cronin**—For the competitive neutrality adjustment, we used the bond rate plus three per cent.

**Senator CONROY**—Did OASITO use a different figure?

**Mr Cronin**—Yes, they used a higher figure. We used a lower figure, which relates back to the notion that given that there was a financial lease it was the Commonwealth who bore the risk of ownership. As we bore the risk of ownership, we considered a lower risk premium should apply rather than the higher risk premium which OASITO applied.

**Senator CONROY**—Could I just get two numbers there? I do not know what the bond rate is plus three per cent.

**Mr Cronin**—The bond rate was around six per cent.

**Senator CONROY**—So that makes it around nine per cent. And they were using?

**Mr Cronin**—They used around 12.89 per cent, from memory.

**Ms Long**—They are actually listed in the report in figure 7.4 on page 176. The rates that were used by OASITO are in the top part and the rates used by us are in the second part.

**Mr Barrett**—I would just reiterate that we are not saying anything here tonight that is not actually in the report. We are happy to take the committee through the report, but all the pertinent issues and the facts on which the judgments and recommendations were made, as usual, are in the report itself.

**Senator CONROY**—Unfortunately, having sat through OASITO's evidence, I feel compelled to give you an opportunity to respond, even though it is here in writing, to some of the issues they have raised. I am seeking a response from you. I am happy for you to say no, that is the page that rebuts that. I am really trying to get to where their heads are at because they have not been as forthcoming as you have on some of the information you have supplied to us.

**Mr Cronin**—With the financial analysis, it may help if we took you from the transfer of the assets to the vendor right through to how our analysis actually works. We are constantly running across between the concepts of agency assets and finance leases, and there is quite a bit of mixing of concepts going on, so it is quite a complex thing. Basically, the Commonwealth transfers at handover to the vendor in exchange for a payment of money. This ranged between two-thirds of the net book value that we had in the evaluation, down to about one-twentieth of

their net book values. The lower the amount that is paid up-front to the agency results in lower rentals over the life of the assets, which leads us then into the first question which is end of term agency assets.

As we have discussed, we count the residual values of the assets to the agencies because we consider that, if an agency buys assets in the fifth year of the evaluation, those assets may have a three-year life. So there are values in years 6 and 7. OASITO's analysis only counts to the agency a cost; it does not count on the other side a benefit for those years 6 and 7. When we get into the end of term vendor assets, we are counting those Commonwealth obligations at the end of the period where, if the contract is not extended, there are obligations that come back to the Commonwealth. We would say that, given that the price of hardware in the technology field is constantly changing and generally falling, it is very easy to have an asset which may be held on your books at a higher value than it will actually get in the market if you were to sell it. Given that the Commonwealth is liable for that loss, if we roll over the contract, we would be paying a higher amount of money for something that is not giving us the same level of service. So for the evaluation period we include that within it.

Those areas become the financial savings. We then move into adjustments we make on the competitive neutrality, which are notional savings. The two main ones are, as you point out, the question of the weighted average cost of capital, which we apply a lower discount rate to, tying back to the nature of finance leases. If we have got the risk of ownership, we cannot see why we would compensate or in fact penalise the agencies versus the outsourcer. The other one relates to how OASITO treated the competitive neutrality on Cluster 3. We consider that they overinflated the competitive neutrality savings because they applied the cost of capital to the turnover and not to assets. For example, it would be like asking the Commonwealth Bank to get a 15 per cent return on their deposits as opposed to the equity they have invested.

As a result of that, we have the following financial outcomes: Cluster 3, in our analysis, barely moves from what was reported; there are significant decreases in the reported savings on the ATO on the financials; and on Group 5 the response is that OASITO reported a small, \$960,000 saving over five years but we report a \$7.15 million loss.

**Senator CONROY**—Thank you very much.

**Senator WATSON**—What was the rationale for using turnover instead of assets? You would have to use different figures if you used turnover compared with assets.

**Mr Cronin**—The question of turnover arose from advice that OASITO received from the Department of Finance and Administration which they considered was incorrect—we agree with them that it was incorrect—and they adjusted their subsequent methodology in Group 5 and ATO. They applied the weighted average cost of capital to assets and not to turnover, which results in a significant drop in the competitive neutrality adjustment.

**Senator WATSON**—But what was the rationale of the department of finance for choosing that basis? It is not a common method of valuation, is it, unless you are using a different formula.

**Mr Cronin**—There are two things. The weighted average cost of capital, in terms of deriving a number there, is quite well accepted.

**Senator WATSON**—Yes, that is right.

**Mr Cronin**—I had never seen it applied to turnover, and I believe it was an error that was corrected. OASITO brought this error to the—

**Senator WATSON**—How long was that error perpetuated? As I said, that was the first thing I picked up when you gave us that method.

**Mr Cronin**—OASITO advised DOFA in August 1998, I think, that they had concerns about the DOFA methodology which had been conveyed to them in December 1997, from memory. There was quite a time lag. OASITO, in Group 5 and ATO, adopted a correct methodology in applying the weighted average cost of capital to assets.

**Senator WATSON**—But in your overall analysis you applied the correct formula, did you, consistently?

**Mr Cronin**—We applied a weighted average cost of capital consistently.

**Senator WATSON**—What was the difference in dollars in terms of the two results?

**Mr Cronin**—They are shown in figure 1.

**Senator WATSON**—Just give it to me.

**Mr Cronin**—Tina, perhaps you would like to run through them.

**Ms Long**—The only tender evaluation in which what we view as the incorrect methodology was used was Cluster 3. Figure 1 in the summary, on page 19, shows that the dollar effect of that in nominal terms was a \$22.39 million reduction to the adjustment that was previously made to the agency baselines. But that was the only tender in which that was applicable.

**Senator WATSON**—That reduced the cost of savings, didn't it?

**Ms Long**—It reduced the post-competitive neutrality notional savings, yes.

**Mr Cronin**—By \$22 million.

**Senator WATSON**—A significant difference.

**Mr Cronin**—The lower discount rate we used, which was the bond rate plus three per cent, reduced ATO's by nearly \$10 million and Group 5 by nearly \$1.5 million. In comparison those adjustments, while significant, were not as marked as the methodological change on Cluster 3.

**Senator CONROY**—I will come back to a couple of issues on the ATO. I asked whether the ATO agreed with this new methodology. Don't they have to agree? Or is there a situation where OASITO could impose this? You were pointing me to some words from the tax office, which clearly seemed to show that they were unhappy. Who has the final say there and do you have correspondence from ATO indicating that they think this is not a satisfactory situation?

**Mr Cronin**—What is shown in paragraph 7.51 or 7.52.

**Senator CONROY**—I think it was 7.51.

**Mr Cronin**—That actually is a direct quote. We have a quote from them.

**Senator CONROY**—I am just hoping to try and get something in English for listeners.

**Mr Cronin**—Essentially, as the Auditor-General mentioned earlier, OASITO is responsible for the implementation and has large control. It is their guidelines which drive the financial analysis.

**Ms Long**—There is a template that was developed originally for Cluster 3 and it is used for each tender.

**Senator CONROY**—But they changed the template though between Cluster 3 and ATO.

**Ms Long**—There are some changes that are made but the template is basically identified to the agencies by OASITO.

**Senator CONROY**—Because ATO have had to make some notional cost savings, surely they have some say in the evaluation method. For instance, you suddenly walk up and say, 'Look, these cost savings that you were going to make before, by the way, you are actually going to make much greater ones now because we have changed the methodology.' Tax have an interest in saying, 'Well, just a minute; we do not agree with that method', which is what they seem to be indicating here.

**Mr Cronin**—I think, Senator, you would have to ask each of the individual agencies that specific response.

**Senator CONROY**—Okay, I appreciate that. Earlier on, either Mr Barrett or Mr Cronin used the words regarding the form of lease 'optimising the financial position' in terms of valuing the residual at zero or at some value. I think you used the phrase 'optimise the financials'.

**Mr Cronin**—There are two issues here: the agency issues for the terminal values and the capital exposure the Commonwealth has on the vendors' leases at the end of year 5. They are two issues apart. The Auditor-General might be able to talk in terms of the vendor leases, which goes to the nature of the Commonwealth's obligations to the vendor at the end of year 5 and how you should capture that in your analysis. This gets back to the disagreement we have had with OASITO relating to finance leases and indeed with the Department of Finance and the changes that OASITO has made in its own methodology.

**Senator CONROY**—But the words ‘optimise financial position’ I think were used. These seem to indicate to me—and I am not trying to put words into your mouth—that, by adopting this alternate methodology, they perhaps were not optimising the Commonwealth’s financial position, which would make sense. If you give a value to an asset and then suddenly you say, ‘No, the asset has no value’, there is a reduction in the financial position of the Commonwealth, I would have thought.

**Mr Cronin**—The question comes back to the nature of the tender and what is actually in your tender document. What we audit against is what the Commonwealth has said in the request for tender—the criteria that are laid down. What we audit against is: have we accorded with that tender? This would get back to the notion that, in these three outsourcing contracts that we looked at, there was a precondition that there would be savings. We look at it in terms of that. How you actually determine savings is a disagreement that exists between DOFA, OASITO and the ANAO.

**Senator CONROY**—DOFA are actually backing OASITO’s evaluation method even though it is contrary to DOFA’s own evaluation method?

**Mr Cronin**—DOFA’s whole-of-government response has disagreed with the recommendations we have made.

**Senator CONROY**—Does that mean, implicitly, that they disagree with their own standard that you were holding up before, Mr McPhee?

**Mr McPhee**—That appears to be the case.

**Senator CONROY**—So they are disagreeing with their own standard?

**Mr McPhee**—They may argue that circumstances are different, but I cannot see that they are.

**Mr Barrett**—The reference is to the advice that they have been given and that continues to be the case; we are not disputing that. As I said to you, in my professional view and professional judgment, for the reasons I think that we have indicated to you, we believe that the Commonwealth position was better indicated by the approach that we have suggested where these particular circumstances applied. There was an advice to secretaries from Finance and Administration to the effect that ‘we recognise that there might be grounds for differing views as to how these agreements should be classified. Nevertheless, after reviewing these agreements and seeking specialist advice, DOFA concurs with the view that, on balance, these agreements do not inherently give rise to embedded finance leases. This issue is important as a liability would incorrectly be brought to book if these agreements were inappropriately treated as containing finance leases’.

**Senator CONROY**—And you would strongly disagree with that; professionally you would disagree with that?

**Mr Barrett**—Our own advisers, plus two very prominent Australian experts in this area, would not agree.



**Senator CONROY**—And DOFA in every other case from their own guideline would disagree?

**Mr Barrett**—You might say that experts differ, but they got advice on which they relied.

**CHAIR**—Which document are you reading from? Can it be tabled?

**Mr Barrett**—It was a notification sent to all agencies. As far as I am concerned, I do not see any problem. We could, as a matter of courtesy, ask Finance and Administration—it is their letter—if they have any particular problems with it. It is a straightforward, factual comment to heads of agencies as an advice in the treatment for Cluster 3, Group 5 and the ATO information technology service agreements, which impacted on their financial statements and led to a qualification, for instance, in the case of the Australian Taxation Office.

**CHAIR**—Which is at 7.51.

**Senator CONROY**—I am trying to keep this in layman's terms. My first year accounting fell by the wayside many years ago, so I am trying to keep it in language I can understand. The words 'optimise a financial position' were used before, which would lead me to conclude that, by adopting the alternative method, it is not the optimum financial position for the Commonwealth. Is that an unfair characterisation?

**Mr Barrett**—It depends on how the values were done. As I was saying to you earlier, and perhaps Mr Cronin could answer this, my response to you would be that, if the arithmetic was properly done, when the people sat down to negotiate the outcome—I am not saying we have got it absolutely and utterly right, although I think we do; but let us assume that they accept that we have—they would have worked out the leasing prices on that basis. So if there was a dollar for dollar situation, in one case they would have got a cheaper lease; in the other case they would have got a dearer lease, but they would not have had the residual liability. In essence, if the world was perfect, they should have come out, so long as the contractual arrangement in the first instance recognised that.

**Senator CONROY**—But in this case they started in one position and started a method which led you down to residual value, whereas, if they had started with the other methodology at the beginning, you would have had a lower starting point but you would have had less at the end. Have I got that right?

**Mr Barrett**—Yes. It is a question you might want to put to the individual agencies concerned, to get their view about that.

**Mr McPhee**—Senator Conroy, there is a table on the top of page 154 which may assist on this issue about the comparison of the two approaches. The first line goes across several columns. There is the case where the agency purchases equipment, say, in year 5, at \$9 million for the equipment. There is a cash outlay in that year of \$9 million and nothing in the subsequent two years. The next line down is a lease example, where there is a standard \$3 million charge per annum across the lease term, as you would expect. If you are using a five-year analysis period, that demonstrates that the bias is clearly going to be towards a leasing

option, because you are not taking into account any residual value of the equipment purchased for \$9 million in year 5.

The reason why we say that, from an economic point of view, you need to take into account the disposal value, the residual value, is that it is a resource that retains to the Commonwealth, and Finance's own guidelines and most textbooks will show that you have to take into account the residuals. I think that illustration there shows the reason why we think their methodology was deficient and why it would bias a decision towards a leasing outcome on that basis.

**CHAIR**—Just on that, Mr McPhee: can you give a layman's simple explanation of why DOFA disagreed with the four recommendations which they disagreed with in the whole-of-government approach, and which I think in part go to this? What is it that they are referring to when they talk about the advice and government policy on outsourcing?

**Mr McPhee**—I cannot explain it, but I will see if my colleagues can help me out.

**Mr Cronin**—This is recommendation 14, paragraph 7.44, and recommendation 12, paragraph 7.17?

**CHAIR**—Yes, and also, I think, in paragraph 4.61, recommendation 8. They all seem to be in part related very much to what Mr McPhee just said. But there is a reference in their response to you which talks about the government's IT outsourcing policy and advice.

**Mr Cronin**—If we could split into these into two components: recommendation 8 relates to the notion of evaluation and tender assessment, which relates essentially to criteria. What we talked about in recommendations 12 and 14 relates essentially to methodological differences between the Department of Finance and Administration's whole-of-government response and the ANAO. Chairman, which order would you like to handle these in?

**CHAIR**—Whichever assists you in giving us the simplest explanation.

**Mr Cronin**—I think we will have Ms Long lead off on recommendation 8.

**Ms Long**—Recommendation 8 relates to the tender planning process, or the evaluation planning process. The requests for tender that were issued in respect to the tenders that we were looking at set out a very clear hierarchy of evaluation criteria, and those criteria would then be used to select the preferred tenderer.

As you work your way through the hierarchy, which is set out in figure 4.2 on page 93, once tenderers had gotten over a threshold issue of being satisfactory in terms of service and risk, they were eligible to be further considered in terms of savings. If they offered substantial and acceptable savings, which had been identified as a precondition to the awarding of a contract, it was then an issue of whether there were two or more tenderers offering substantial savings. If there were, then the preferred tenderer would be selected on the basis of the best combination of savings and industry development.

Our basic point with recommendation 8 is that in the evaluation planning process there was no articulation of how those two quite separate criteria—and the evaluations against those two

criteria were conducted quite separately—would then be combined to determine the preferred tenderer. It is accepted administrative practice that the means by which you are going to apply the evaluation criteria should be determined before you commence evaluating, as a probity issue and a good administrative practice issue. We have recommended that, in future tenders where a combination of criteria is going to be used to determine the preferred tenderer, there should be some articulation of how that process will actually come through. We are not too sure exactly why there is a disagreement to that recommendation, because it is accepted administrative practice. The response refers to government policy objectives—and, indeed, cost savings and industry development were identified as the primary objectives in each of these tenders—but how that goes to the point that we were making is not clear.

**CHAIR**—That was really the point I was making, because it seemed to me that those two issues you raise are very much Commonwealth policy objectives. But they are saying here, in their response, that the evaluation planning process is clear and takes full account of government policy objectives. Did they identify what those government policy objectives were, or is this just a broad generic statement?

**Mr Barrett**—It comes back to our earlier discussion about balance and assessing the impact of other policy objectives. I remember that we talked about guidance, and needing sufficient guidance or some methodology—if it was not possible to be quantitative then at least some qualitative factor, so that you can at least explain and so that when you do bring these together you can see how the combination distinguishes between one tenderer and another.

**CHAIR**—And what weighting you give to one preference or the other, given certain circumstances.

**Mr Barrett**—Yes. I think we made a pretty straightforward recommendation: that we think it should be much more transparent and the basis be made clearer so that people understand. I know that sometimes this is difficult—when you have issues that are very hard to assess at the time without any information that will allow you to make a reasonable assessment—but sometimes you can do that from other contracting out arrangements when you have witnessed what the actual outcome was in terms of, say, Australian industry involvement, the extent to which firms were more competitive and were actually part of the tendering process where they had not been before. It just means, simply: let us get this much more transparent and clear so that people know where they stand.

**CHAIR**—It could also go to whether or not, if you were interested in promoting a local IT industry, you were prepared to do it through direct subsidy or indirect subsidy, through preference or purchase for locally produced goods which, again, would then give a greater weighting to that industry development criteria, as opposed to the weighting that is given to—

**Mr Barrett**—Just to put a little balance in the conversation from my perspective at least, I have some sympathy here if, for instance, the view was that the Australian firms were not getting sufficient access and this was a means of ensuring that they did. It is very hard, and the real question then becomes—as, in fact, the later contractual arrangements have shown—the extent to which there is a degree of longevity in terms of the Australian firms that continue to be part of the contractual arrangement. In that instance, that would be one test at least—and, if they did not survive, why didn't they survive, what was the reason for it?

**CHAIR**—That would be a relatively easy test to apply.

**Mr Barrett**—There should be indicative information, I would suggest, and at least people could make some reasonable assessment. Even it was a case of determining the likelihood—whether it was a 60 per cent, 70 per cent, 80 per cent likelihood—of achievement, at least someone who is an expert and really has got some basis for making a reasonable judgment in this area might be prepared to say, ‘Look, if you do it this way and get them involved, you have got a better than fifty-fifty chance or a 75 per cent chance of at least ensuring that this actually will occur.’ Obviously if there is a risk attached, like with anything else, you have got to make a risk analysis and you have got to have the range that you are prepared to tolerate—that is, are you going to be within an acceptable range or not?

**CHAIR**—And you would know the cost of doing that—you would be able to measure the cost of doing that.

**Mr Barrett**—Yes, we would try to measure everything that is measurable at least.

**CHAIR**—I want to get a similar sort of explanation for 12 and 14.

**Mr Cronin**—Recommendation No. 12 on page 156 is concerning the end of term assets held by agencies and the value. As has been pointed out, OASITO’s valuation methodology does not include the future service potential of those assets. OASITO says that they have a methodology which they have obtained from independent experts which is applicable to their situation.

**CHAIR**—They say ‘applicable government policy’.

**Mr Cronin**—We do not know what applicable government policy is, beyond that outlined in the policy statements and the Prime Minister’s letter. We have not found any government policy that relates down to the treatment of terminal or end of period assets. We have presented the material that was the 1993 department of finance’s publication. Our understanding is that, when all these tenders were completed, OASITO did not actually have independent advice; they received that subsequently. They have indeed moved to a newer methodology, what they call based on equivalents. They received advice in June 2000 on this new methodology.

This new methodology incorporates the notion of liquidating all the positions at the end of the evaluation period. So instead of assuming an ongoing going concern for an agency, you would assume that everything liquidates at the end of the evaluation period, which in this case would be year 5. For example, you would assume that the Australian Taxation Office’s whole position and all the assets and liabilities would be liquidated at the end of year 5. This is a methodology we have had some discussions with OASITO about, but it does not fall within the parameters of the audit as it was not applicable to the Cluster 3, Group 5 and ATO tenders that were reviewed as part of this performance audit.

**CHAIR**—Did they indicate who the independent expert advice was?

**Mr Cronin**—Yes, they have received written advice from PricewaterhouseCoopers.

**Senator CONROY**—Creative fellows.

**CHAIR**—Was that the same advice in respect to recommendation No. 14?

**Mr Cronin**—Recommendation No. 14 goes to the vendor assets, the Commonwealth's obligations at the end of that. As we previously pointed out, OASITO has changed its methodology, going from treating inclusion of this value in the Cluster 3 to the exclusion of these obligations in Group 5 and ATO. At the time at which they conducted the selection of the preferred tenderer for ATO and Group 5 they did not have written advice on the change in methodology, but they did advise agencies in March 1999 that they had changed their methodology.

**CHAIR**—This is the one they got the written advice four months later.

**Mr Cronin**—Yes.

**CHAIR**—Was that also PricewaterhouseCoopers?

**Ms Long**—I think the advice that is being referred to in the response to recommendations 13 and 14 relates to identification of a lease as either a finance or an operating lease. That is separate advice to the advice that relates to an appropriate evaluation methodology.

**Mr Cronin**—We understand that both DOFA and OASITO have got numerous advices from accounting firms on—

**Senator CONROY**—How many times did they have to shop around and get knockbacks before they picked up those?

**Mr Barrett**—We are not in a position to comment.

**Senator CONROY**—You do not know, or you do know but you will not tell us?

**Mr Barrett**—I genuinely do not know. We are not in a position to comment on that. The firms concerned are highly respectable firms. We accept that.

**Senator CONROY**—Do you think a business would have accepted this sort of advice? If they gave this sort of advice to a corporation, would a corporation take it?

**Mr Barrett**—Do you mean this particular advice? Advice in general, obviously they do.

**Senator CONROY**—I mean financial leases versus operational. You describe this as the normal corporate practice. I am saying if PWC turned up with this to a corporate, do you think they would cop it?

**Mr Cronin**—This is professional advice so, depending on the circumstances, professional judgments are in play here.

**Senator WATSON**—Can you give us the details of your advices, what you have received from various professional people, together with the advices received from the agencies in terms

of the conclusions that they have come to? We have really got a situation where we have your advices on the one hand, your recommendations, and DOFA agreeing or disagreeing with you. Somehow we are going to have to look at those advices and maybe get a consultant in to be able to evaluate which is correct.

**Mr Barrett**—As I was saying earlier, I do not have any choice in this matter.

**Senator WATSON**—We are making inquiries. We have recommendations which differ. In fairness, we have to evaluate the basis on which you came to your conclusions; we have to evaluate the basis on which the other people came to their conclusions.

**Mr Barrett**—I understand.

**Senator CONROY**—There are advices on your side and these two verbal advices over here, and we have to make a judgment.

**Senator WATSON**—So we almost have got to get some sort of independent consultant to evaluate the technical features of each of the advices and how they apply in the limited circumstances of each cluster.

**Mr Barrett**—I am not here to tell the committee how it does its work.

**Senator WATSON**—Can you give us the basis of your advices and the advices that you have got in terms of—

**Mr Barrett**—We actually have done so.

**Senator WATSON**—We have got that now, have we?

**Mr Barrett**—We have told the Senate committee.

**Senator WATSON**—Have you also tendered the advices that the agencies had that you had access to, because we would also need that?

**Mr Cronin**—There is one point here. OASITO actually did not get any advices prior to the execution of the contracts. They received these advices much later. In terms of what we are talking about, this came in at the latter stage of the audit. These contracts were entered into in 1998 and 1999, two in 1999, and one in 1998.

**Senator WATSON**—But in terms of making evaluations and in terms of cost savings, there must be certain criteria on which they have made their analysis. You have made certain valid adjustments but at the same time we have also got to evaluate that 69 figure to make sure that that is authentic and the basis on which the specifications were set, and why.

**Mr Barrett**—We totally agree with you. We had explained earlier—

**Senator WATSON**—I just want the documentation, that is all.

**Mr Barrett**—We had explained earlier that OASITO had changed its guidance. In other words—as Mr Cronin was saying to you—there was a situation prior to contracts, and we have explained to the committee that there were variations of advice following that at various periods of time, finally leading up to a situation in which a decision was taken that these should be treated as operating leases. I have explained to the committee that in some cases we accepted that the nature of the transactions was operating leases. In other cases, we indicated that for the financial statement audit treatment the issue was not material to the accounts, but we have indicated to the agencies concerned that it would be better practice in the future to treat these as finance leases in the circumstances that reflected that. We are happy to make the actual letters of advices available to the committee.

**Senator CONROY**—Are you aware of any other jurisdictions where this methodology applies at the moment?

**Mr Barrett**—It is a general problem.

**Senator CONROY**—A general problem?

**Mr Barrett**—It is a general issue, and that is why the standards board is having to come to grips with this. We gave you the indication that the draft standard is clearly in favour of making the liabilities and the assets visible in the financial statements. I do not think there is any doubt as to where the profession is heading, but there clearly are at least two opinions that I can recall that DOFA got, and we have two opinions that we got, plus the opinions of our own experts, plus the indicative direction that the standards bodies are going in. And the sole focus—

**Senator CONROY**—But there is an established standard at the moment, albeit that it is possible to have an argument about it. In other cases in the corporate world where there is a dispute over accounting standards interpretation, ASIC is fairly active. You may even have seen in today's papers that they have taken MYOB to court over a particular valuation method. Is ASIC able to look at this case or is ASIC excluded from looking at government departments?

**Mr McPhee**—I do not think their charter goes to—

**Senator CONROY**—Shonky government practices.

**Mr McPhee**—Commonwealth agencies or statutory authorities. It would go to government companies. We can check that, but I think that is right.

**Senator CONROY**—You do not think ASIC could have a chat with them and say, 'Look, if you were a corporate, you would be in court by now'?

**Mr Cronin**—This relates essentially to an internal investment decision making process of which option they will choose, so it is internal to the organisation. Whether people make appropriate use of their funds or waste them is—

**Senator CONROY**—No, ASIC prosecute companies on the basis of the valuation methods. They look at their accounts and say, 'No, you are accounting for this in an incorrect way. Here is the accounting standard. We're not going to let you put an account out to the marketplace that

accounts in this method.’ That is actually what they are doing to MYOB right now. They have said, ‘You must come back and use the proper method.’ I was just hoping that maybe ASIC could come in to assist you on this, but it appears not, so I will move on. Are you aware of any other examples that DOFA use this method in?

**Mr Cronin**—The question of finance lease and operating lease has come up in other contexts. The 1998-99 audit of the sale of DASFleet raised the question of operating or financial leases. In the initial sale of DASFleet the Commonwealth believed it was entering into an operating lease. About 12 months after the sale had been executed, a finance lease was determined to operate at a whole-of-government level for the DASFleet. So the question of getting appropriate accounting advice to determine the transaction you are entering into can have quite material implications for the Commonwealth. It has a major impact on a transaction, whether you are entering into an operating lease or a finance lease. That is another one which has involved questions of operating or finance leases.

**Senator CONROY**—So they initially went down the path of an operational lease but came back to the field, if you like, of the more normal accounting practice. It was really a financial lease?

**Mr Cronin**—It went into it as an operating lease; it was subsequently determined to be a financial lease.

**Senator CONROY**—I am in no position to make a judgment. Do you think there is a comparable situation between the DASFleet and this IT? Both are assets owned at the beginning of the process, going down this path. Are they analogous.

**Mr Cronin**—We believe—and we have repeatedly stressed this—that you should get appropriate expert advice to determine the contractual commitments you are signing up to, because the contractual commitments for an operating lease are quite different from those of a finance lease. It is imperative that when you enter a transaction, you understand the economic substance of that transaction. Advice prior to the execution of a contract is essential to aid the decision maker to decide what is the best financial outcome for the Commonwealth.

**Mr Barrett**—I think we would argue that there are lessons to be learnt here. What we would say in relation to the comments that were made earlier by Mr Cronin was that these kinds of issues are so important that they need to be resolved prior to going into a tender process. I think that is really the lesson learnt here. While I am saying that the standards seem to be going into an area of collapsing the so-called differences between operating and financial leases, in fact there will be only one standard for leases and it will be one that will be transparent. In other words, the amounts should be shown in the financial statements, as Ms O’Brien said earlier. That seems to be the way it is going. Clearly, if that is the case, then there should be no problem. But it is indicative that in these areas you need to get appropriate advice early in the process and learn from that, and this is really—

**Senator CONROY**—Presumably they did, though. They started off with a contract in one particular form. It was only in the last days that they actually changed the methodology. When you put a document out to tender—and I have never been through this process—presumably



you have taken advice. Presumably they did have an agreed method because people tendered on the basis of a particular method.

**Mr Barrett**—I think Mr Cronin said that I do not think we discovered any advice early on this issue.

**Mr Cronin**—We understand that on the Group 5 contract they did not receive advice on leases until 15 months after the contracts were executed.

**Senator CONROY**—That is not a question of learning, though. I am just drawing on it. This is not a question of learning experience.

**Mr Barrett**—But I am simply saying that it is on the audit.

**Senator WATSON**—Did the people who tendered know the basis of the leasing arrangements that they were tendering on.

**Mr Cronin**—It is important that both sides understand that, Senator.

**Senator WATSON**—That is the question. Did you ask that? Did both sides understand the nature of the leasing arrangements on which they were basing their tender—and the financial outcomes of the consequence of each decision if it was operating vis-a-vis a financial lease?

**Mr Barrett**—There are circumstances in which probably the answer is no, and there are circumstances in which there probably was a suggestion that the agency may have agreed with the position that we were taking.

**Senator WATSON**—Do you agree that there would be differences in outcome for the tenderer? Do you presume their tender documents would include an understanding of the nature of the leasing arrangements which they are tendering on? Did you look at the basis of the tender for any of these people?

**Mr Cronin**—Yes, we did. There was confusion, for example, in Group 5. This was a tender that closed in August and the preferred tenderer was not selected for seven months. There appears to be evidence that the people who bid did not fully understand what they were bidding for.

**Senator WATSON**—Yes, that was my question.

**Mr Cronin**—This appears quite late in the piece that people actually grasp that they did not have to cover the residual risk at the end. In the Group 5 contract, what happens is that, not only is the Commonwealth exposed for the assets but it is also exposed for the lease liability.

**Senator WATSON**—So the risk was not with the—

**Mr Cronin**—No. The whole leasing transaction is passed to the Commonwealth, so we are up for the question of the assets as well as the lease liability.

**Senator WATSON**—So that is what you built back into your calculations?

**Mr Cronin**—Yes. We did an estimate of that. So Group 5 has a variation on it again, but that clear understanding at an early stage, of where the risks and benefits lie, has a marked impact on what tenderers bid.

**Senator WATSON**—Of course, that is why I asked you: did they understand the nature of the document that they were signing to?

**Mr Cronin**—Generally speaking, if people clearly understand what they are bidding for, the bidding process tends to be very quick and efficient. It is where there is confusion that it may tend to be delayed as clarification is sought, and a considerable amount of clarification is required on these contracts because of their complexity.

**CHAIR**—I have a couple of quick questions, Mr Barrett—I suppose you could call them residual questions. Then I want to give Mr McPhee his opportunity to talk about the confidentiality in government contracts. On the question of industry development, which we were talking about a bit earlier, I think you refer in your report to the requirements for some of these ASPs to report annually to the Department of Communications, Information Technology and the Arts on their achievements against their industry development commitments. These reports that they make, are they confidential reports or are they publicly available? Did you do any assessment of any of those reports to see whether or not they actually were meeting the commitments that they had entered into in respect of industry development?

**Ms Long**—At the time we were doing our fieldwork, there had been only one annual report due, that was by the Cluster 3 external service provider. As is the case with all of the reports, the contracts actually require that the report be independently audited at the expense of the provider and that the report and that independent audit report then be provided to the Department of Communications, Information Technology and the Arts, who have responsibility for that monitoring role. In the scope of what we were doing in the audit, we did not seek to, I suppose, mirror that audit process of the report that had been provided by the Cluster 3 provider. What we looked at were the arrangements that were in place from DOCITA's end to provide some sort of assurance in that process. We looked at the process by which the independent audit is arranged.

The review, as it actually was, of the Cluster 3 provider's first report was conducted as a review engagement, which is a set of agreed procedures that were agreed between the provider and the auditor. In any audit engagement, there is a combination between the scope of the audit and the tasks that are going to be involved, and the cost factor associated with that, and the level of assurance that is actually being sought. The highest level of assurance that can be provided under the current auditing standards is an audit, and a review engagement is a lower level of assurance.

The point we made to DOCITA was that there did not seem to be an understanding within DOCITA of exactly what type of engagement was going to be arranged by the external provider, and what type of assurance the Commonwealth was actually seeking. It may very well be that a review engagement was all the sort of assurance that was being sought, but there was not that understanding up front. In dialogue with DOCITA, in the course of the audit, they engaged their

internal auditor to review their procedures in that regard, and they now have revised guidelines which require that DOCITA agree with the provider, before the engagement is set up, what type of audit would be provided on the annual report that is going to be then provided to DOCITA. We were going to make a recommendation in that regard. Action was already taken, so we have just noted in the report that that was the case. Subsequently, other annual reports have come due, but we were not involved in any review of those because of the timing of the audit.

**Mr Barrett**—Are they public?

**Ms Long**—Not to my knowledge. My understanding is that they are provided to DOCITA, who look at them in their monitoring role. I do not have any knowledge that they provide them to anybody further than that.

**CHAIR**—And we do not know whether or not, or how, DOCITA assess whether they are adequate, whether they are being carried out or whether it is simply—

**Ms Long**—The process is that there are obligations and milestones—whether in dollar terms, employment terms or whatever—identified in the industry development plan that the tenderer puts forward; they then are incorporated into the contract.

**CHAIR**—I understand that, but is an actual audit carried out? I have seen these before, in another life, and I am not aware whether there has been an actual audit carried out against the commitments that suppliers have made in respect of industry development.

**Ms Long**—The only audit that I am aware is carried out at this stage is the independent audit that the provider is required to have done on the report before he provides it to DOCITA.

**CHAIR**—DOCITA itself does not independently test whether or not the commitments that have been given have been actually—

**Ms Long**—Not that I am aware of. They will obviously review the report as they get it, and they do have ongoing contact with the providers in the course of the year, to see how they are going against their milestones, based on the information provided by the provider. Other than that, I am not aware of any.

**Mr Barrett**—We are at a disadvantage because we only looked at that one case, and after that DOCITA improved their methodologies. I respectfully suggest to the committee, if they want to pursue that, that it is appropriate to ask DOCITA what they are now doing. We made specific suggestions; they reacted positively; we have recorded that in the report. But as to the further point which you rightly asked, we cannot give you an answer today.

**CHAIR**—I accept that, but I presume that at some stage down the track, Mr Barrett, the Audit Office again will make some analysis or assessment of these contracts. I would ask you simply to take on board some of these non-financial commitments, if I may use that term.

**Mr Barrett**—We learn from these audits as well, Mr Chairman, I can assure you, and these are the sorts of things that you do need to bear in mind and take account of. We will be commencing an audit next March.

**Mr Cronin**—Yes, into the health group.

**CHAIR**—Have a good rest over the break and be sure your health is all right! In respect of the budget cuts: in anticipation of cuts being delivered out this process there were allowances made in the forward estimates of the budget in terms of funding to the agencies—a bit like the performance pay and efficiencies in the department. When you did your assessment, were you able to identify where these savings were not made, whether or not they impacted upon service delivery by agencies and, in terms of the end product—I suppose we may use that term—to the customer, whether that has been significant in areas, or was that an assessment that was not made from scratch?

**Mr McPhee**—It was not made directly, Mr Chairman. It would have extended the audit off into another arena so we did not look at that specifically in this audit.

**Mr Barrett**—I think you will find, if you ask at least a couple of the agencies, that they are still looking for the savings. I am not saying that in a joking manner. I think that they legitimately have got a problem of actually identifying their savings.

**CHAIR**—I accept that, and I suppose that at the end of the day, if they cannot find the savings and if there have been cuts to their budgets in expectation of savings, ultimately that has to impact upon the service delivery by those agencies.

**Mr Barrett**—In regard to the budgets of recent years, I think that is not an unreasonable conclusion to reach. It is not as if they have got plenty of funds.

**CHAIR**—Given that it is 10 minutes to 10, we might move on, Mr McPhee, to get a brief overview from you in terms of the audit that is being conducted on the confidentiality statements in government contracts.

**Mr McPhee**—Thank you, Chairman. The audit is going along quite well. We are at the stage where we have consulted with the agencies and we are about to prepare four papers, basically. One is to do with the existing guidance that agencies have about commercial-in-confidence or confidentiality information in contracts, and we are looking at their current practice as well. So the first paper will deal with guidelines and practice. The second paper will deal with, broadly, what is happening in other jurisdictions. We will pick up, for instance, what is happening in Victoria and maybe overseas, to the extent that we can. The third paper will deal with, broadly, some of the legal issues, dealing with what is a contract and what some criteria might be that could assist agencies in determining whether information is indeed confidential and should attract confidentiality provisions. The fourth broad area we are looking at is the reporting in the *Gazette*, to see the accuracy and comprehensiveness of reporting in the GAAP system or the *Gazette* system. That is broadly the situation.

We have consulted fairly widely. We are talking to industry, as you would be aware, and we are talking to parliamentary committees about instances where they have been denied access to contract information. We think we are getting a pretty good handle on the situation. We are also looking at a sample of about 60 contracts, just to see what judgments have been made about confidentiality provisions, to see how those judgments might line up against the criteria we have been given by the Australian Government Solicitor, to respond to the particular reference from

the committee. Things are going quite well. We expect at this stage to table a report in June next year, or thereabouts, and we are making pretty good progress.

**CHAIR**—In the assessment that you are making, one of the issues that trouble me from the point of view of my role as a senator generally, not just as a chair of this committee, is public accountability. Quite often you get confronted with a set of circumstances, whether it is through these committee processes or whether it is through estimates, when in questioning either public servants or ministers about issues you are told, ‘We cannot answer that because it is commercial-in-confidence.’ It may well be a legitimate claim that they make. The problem we have from our perspective is that there is no way in which we can test whether it is a legitimate claim and therefore is entitled to that blanket of cover, or whether it is just being used as a mechanism for avoiding giving answers or being accountable to various committees. It is a fine line, and I do not know how you actually get at it at the end of the day, other than to have some appellate court you can go to.

**Senator CONROY**—Or be elected to government.

**CHAIR**—Yes, but then you might take a different view about whether or not you want the accountability. I am just wondering whether or not you are looking at this question of some mechanism whereby decisions of this nature can be appealed and some judgment made about whether or not that is a legitimate basis upon which to refuse the information.

**Mr Barrett**—My colleague will no doubt have some views that would be of interest to the committee, but I am on record as saying—and this has been subsequently agreed by parliamentary committees—that one test should be that the onus of proof should be on those people who want to argue that information should be kept confidential. That is an important test—it is not light—and I think the committees could quite legitimately put that to any respondent.

I would hope that, in the reviews to which Mr McPhee referred of these contracts that we have selected, when we look at the basis on which the agencies have determined whether or not particular aspects are confidential or not, we will be instructive in the sense that we will then be able to give the parliament some more valid and substantive information on what has been the practice—and its justification or lack thereof. The Victorian case is now a widely publicised situation around Australia, and was discussed recently in the national conference of the Institute of Public Administration Australia. The point made by the chair of the public accounts and estimates committee at that conference—as I recall what he said—was that the government of the day did not agree that information provided in tenders necessarily should be made public, because there may well be intellectual information of commercial value when people are indicating in a tender process what they could do to help you to resolve your particular problem. But certainly, as has been the case and supported by a number of audit offices around Australia, once a contract is signed then there would be very few cases that audit offices have looked at—probably literally hundreds—that would have warranted such information being kept confidential. I am talking about once a contract is signed.

Parliamentary committees of this parliament have said that for some time. They have said they find it very difficult to understand why, once a contract has been signed and is in the public arena, the details of those contracts cannot be made public. In essence, this happens in the

United States of America, for instance. When questions have been asked of various contractors, the preponderance of answers—as, indeed, the Victorian committee found—was that the private sector were quite relaxed about having those contract details made public in those circumstances.

I think it is an issue of our trying this time—and we need to talk to the private sector about this as well—to identify those circumstances in which we can clearly delineate a private asset, if I may describe it in that way, that could be undermined if certain information in relation to a contract were made public. At this stage, the obvious one is intellectual property. But once that intellectual property is then brought to bear in a contract, particularly when it is made available broadly throughout an agency, you can hardly argue that it is confidential. Certainly at the tender stage that is a different matter.

I would hope that we can answer the question that you have, legitimately, put to us by looking at those contracts and trying to establish what are the circumstances in which decisions have been made and the justification for that, and then extrapolating from that: in the future what decisions can still be made in the light of that experience and in the light of people's general view now of the reversal of proof? That is, if people want to make information confidential, they have to have substantive reasons for doing so. If we can come back to you with a report like that, I think it will help you in the conundrum that you put to us.

**CHAIR**—It would certainly lay a solid foundation.

**Mr Barrett**—Yes.

**Senator CONROY**—You have not noticed a reluctance anywhere else in the world so that, when they know up front that it will be publicly released, people just stop tendering?

**Mr Barrett**—There are a number of countries where contracts are made public, and the United States is a classic example.

**Senator CONROY**—And people still bother to tender?

**Mr Barrett**—The information we get back from the general accounting office in the United States would suggest that this has not been a factor. I actually raised this—and it might be a matter of interest to the committee—with the chairman of the Victorian PA and EC when I attended a discussion and presentation in Perth. I asked him exactly that question: whether the committee found that kind of reticence. The answer was clearly no. In other words, there was not any evidence to suggest that—

**Senator CONROY**—They would still tend to make a buck.

**Mr Barrett**—this was an inhibiting factor.

**CHAIR**—Mr McPhee, I think you said in your opening comments that you were doing papers on each of the four points you referred to. Will those papers be available progressively before your report is completed, or will we have to wait for the report in June?

**Mr McPhee**—It is part of our due process to make sure we fully understand the issues and to flush them out. So they would not be public documents; they are papers we provide to agencies to make sure we are understanding the situation and to allow them to provide us with comments. As we mentioned in the earlier part of tonight's hearing, we will then go to a draft report and, similarly, we will seek comments on that from agencies. A very important outcome from our due process is to make sure we get the balance and understanding right. So these four papers are probably some of the early work that agencies will see as a result of this audit, and so we would rather not make them available to the committee or make them public because we want to test them a bit further ourselves.

**Mr Barrett**—Again, there could be a natural justice issue related to the private sector involvement and, if we have not got it right, that is a problem. So I think that is the reason; it is not just an undue caution. The fact is that it does give justice to all. The issues papers are what they say they are—they are the issues that the team has identified and explained their understanding. They may not be the issues, our understanding may not be correct and the information may not be correct or may be only partial. We are very careful with these issues papers because we have got to ensure that justice is not only done but is seen to be done as well.

**CHAIR**—As there are no further questions, Mr Barrett, that just about concludes our proceedings. Just before I conclude the hearing, I will just say that we will be calling for submissions in January on the issues which we have discussed tonight, and we will be extending an invitation to Mr Humphry, who is conducting the other inquiry on this matter and reporting to the government. Hopefully, he will come and give evidence to the committee some time in the new year. We would like the opportunity to invite your organisation back again once we have some of this evidence on the table to get your comments and views on that, if you are agreeable. On behalf of the committee, thank you very much for making yourself available at this time of the year and at this time of the evening. We have appreciated the information that you have been able to give the committee. Certainly, I think it has helped us to identify what some of the key issues are that we have to try and address and focus on in this whole outsourcing issue in terms of what we might report to the parliament as a committee. I thank you and your associates very much for your evidence this evening.

**Mr Barrett**—Thank you, Mr Chairman.

**CHAIR**—As I stated earlier, the committee will call for public submissions through the media and on the web site in January. Those interested in following the inquiry should refer to the committee's Internet page for progress, updates and copies of relevant documents on an ongoing basis.

**Committee adjourned at 10.04 p.m.**