

The Auditor-General
Audit Report No.32 2012–13
Performance Audit

Grants for the Construction of the Adelaide Desalination Plant

Department of Sustainability, Environment, Water,
Population and Communities
Department of Finance and Deregulation
Department of the Prime Minister and Cabinet

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ISSN 1036-7632

ISBN 0 642 81327 2 (Print)

ISBN 0 642 81328 0 (On-line)

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Canberra ACT
7 May 2013

Dear Mr President
Dear Madam Speaker

The Australian National Audit Office has undertaken an independent performance audit in the Department of Sustainability, Environment, Water, Population and Communities, the Department of Finance and Deregulation and the Department of the Prime Minister and Cabinet in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit to the Parliament. The report is titled *Grants for the Construction of the Adelaide Desalination Plant*.

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

Yours sincerely



Ian McPhee
Auditor-General

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

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Abbreviations

ADP	Adelaide Desalination Plant
ANAO	Australian National Audit Office
BCR	Benefit Cost Ratio
BAF	Building Australia Fund
CGGs	Commonwealth Grant Guidelines
COPEs	Commonwealth own-purpose expenses
DSEWPac	Department of Sustainability, Environment, Water, Population and Communities
DEWHA	Department of the Environment, Water, Heritage and the Arts
FFR Act	Federal Financial Relations Act 2009
Finance	Department of Finance and Deregulation
FMA Act	Financial Management and Accountability Act 1997
FMA Regulations	Financial Management and Accountability Regulations 1997
GL	Gigalitres
NUWDP	National Urban Water and Desalination Plan
PM&C	Department of the Prime Minister and Cabinet
SPBC	Strategic Priorities and Budget Committee of Cabinet
Strategic Review	The Strategic Review of the Administration of Australian Government Grant Programs

Summary and Recommendations

Summary

Introduction

1. On 28 October 2007, in response to prolonged drought conditions at that time, the then Opposition announced that a Labor Government would implement a \$1 billion National Urban Water and Desalination Plan (NUWDP) to help secure the water supplies of Australia's major cities.¹ The NUWDP was outlined in the election policy document *Labor's national plan to tackle the water crisis*. That document also included a number of other announcements, including that a Labor Government would be a financial partner in a carbon neutral desalination plant for Adelaide, if the state proceeded with this project.

2. Program guidelines for the NUWDP were issued in December 2008, at the same time that applications opened to a major projects funding round (which closed on 30 June 2009). Those guidelines reflected decisions taken after the election that NUWDP funding would be used to meet the cost of the Adelaide Desalination Plant (ADP) election commitment (subject to a proposal from the South Australian government that met the program's criteria), and four other election announcements.² The NUWDP guidelines included program eligibility and merit assessment criteria, which reflected the program objectives. The merit criteria were:

1. Level of contribution to enhancing water supply security within the targeted urban area.
2. Cost-effectiveness of the project.
3. Cost-effectiveness of the Australian Government contribution.
4. Demonstrable evidence that the proposed project is a key strategic element of the preferred long-term water supply plan for the area.
5. Extent of environmental benefits and/or environmental best practice initiatives.

¹ Kevin Rudd and Anthony Albanese, *Federal Labor's \$1 Billion National Urban Water and Desalination Plan*, Media Statement, 28 October 2007.

² Specifically, on 28 April 2008 as part of the 2008–09 Budget process, when agreeing to \$1 billion of funding over six years for the NUWDP, Ministers decided that five election commitments, including the ADP, should be funded from within the NUWDP. It was further decided that any use of NUWDP funds to make a financial contribution to the ADP was 'subject to a proposal from the South Australian Government, which meets the program criteria'.

3. Under the NUWDP, a total of \$328 million has been paid by the Australian Government for the construction of the ADP. Two grants have been awarded, as follows:

- in March 2009, the then Minister for Climate Change and Water approved \$100 million to support the construction of a 50 gegalitre (GL) per year ADP. This grant related to the 2007 election announcement. The total value of the project was estimated to be \$1.374 billion; and
- in April 2009, the Strategic Priorities and Budget Committee (SPBC) of Cabinet decided that a further grant of \$228 million should be awarded towards the estimated \$456 million cost of expanding the capacity of the ADP to 100GL per annum.

4. The two grants were announced on 12 May 2009 (Budget day) by the then Minister for Climate Change and Water.³ The announcement clearly identified that the first grant towards the cost of a 50GL per annum ADP related to the 2007 election commitment and that the second grant related to a separate decision to award funding to expand the plant's capacity. Specifically, it was announced that the Government:

- 'has already acted by meeting its election commitment to provide \$100 million to the 50GL [*per annum*] Adelaide Desalination Plant'; and
- 'will commit a further \$228 million to the Adelaide Desalination Plant if capacity is expanded from 50GL to 100GL per year, reducing South Australia's reliance on the Murray River. ...The commitment will be funded from the Government's *National Urban Water and Desalination Plan*'.

Award of a grant towards a 50GL per annum ADP

5. The election policy document *Labor's national plan to tackle the water crisis* had indicated that all NUWDP program funding would be open to applications, and that any financial contribution towards the construction of the ADP would draw on funds for investing in water infrastructure in the Murray-Darling Basin. However, after the election, it was decided that the cost of any contribution towards the ADP (and four other election announcements) would be met from NUWDP program funding. It was further decided that

³ Senator the Hon Penny Wong, Minister for Climate Change and Water, *Additional \$228 million to Help Secure Adelaide's Water Supply*, Media Release PW Budget 09, 12 May 2009.

providing funding towards the ADP was subject to receiving a proposal from the South Australian Government which met the NUWDP program criteria.

6. In December 2008, the then Department of the Environment, Water, Heritage and the Arts (DEWHA)⁴ obtained a funding application from the South Australian Water Corporation (SA Water) that addressed each of the NUWDP's eligibility and merit assessment criteria. On 27 February 2009, DEWHA briefed the then Minister for Climate Change and Water on its assessment of the SA Water grant proposal, advising that the proposal met the NUWDP program guidelines.

7. Consistent with the department's recommendation, on 23 March 2009, the then Minister approved a \$100 million grant under the NUWDP to the 50GL per annum ADP. An Implementation Plan under the National Partnership Agreement on Water for the Future was agreed to by the then Minister on 11 February 2010. The final payment under this Implementation Plan for the \$100 million grant was made in May 2012.

Award of grant for an expanded ADP

8. Back in October 2008, South Australia (together with other states and territories) had made a submission to Infrastructure Australia⁵ in the context of the development of the first national Infrastructure Priority List.⁶ The South Australian submission included a funding request for a collection of water infrastructure projects, including capital and operating costs to expand the capacity of the ADP to 100GL per annum. The proposal that incorporated an expanded ADP was included on the interim Infrastructure Priority List publicly released in December 2008. In order to develop the final Infrastructure Priority List, Infrastructure Australia sought further information from proponents of those proposals included on the interim Priority List.

9. Infrastructure Australia concluded that the ADP expansion proposal was not supported by robust cost-benefit analysis and, in any event, the

⁴ In September 2010, DEWHA became the Department of Sustainability, Environment, Water, Population and Communities (DSEWPaC). Throughout this report, the department responsible for administering the NUWDP at the relevant point in time is referred to as the DEWHA or DSEWPaC, as appropriate.

⁵ In the context of the 2007 election, the Australian Labor Party reiterated an intention first outlined in 2005 to establish Infrastructure Australia as an independent statutory authority to assist in the planning and coordination of Australia's infrastructure needs. The election policy announcement of the NUWDP had stated that Infrastructure Australia would also undertake an independent cost-benefit assessment of all proposals for NUWDP funding. However, after the election, administrative responsibility for the NUWDP was allocated to DEWHA.

⁶ See ANAO Audit Report No.2 2010–11, *Conduct by Infrastructure Australia of the First National Infrastructure Audit and Development of the Infrastructure Priority List*, Canberra, 23 July 2010.

Benefit Cost Ratio (BCR) calculated for the project was too low such that it did not offer a net economic benefit. Accordingly, Infrastructure Australia did not include the ADP proposal on the final Infrastructure Priority List. In addition, on the basis of Infrastructure Australia's analysis of the proposal's economic merit, Ministers were informed in early April 2009 that the ADP expansion was not eligible for funding from the Building Australia Fund.

10. Related to the Infrastructure Australia process⁷, the then South Australian Premier provided two written submissions to the then Prime Minister in February and March 2009 seeking Australian Government funding for the full cost of an expanded ADP. The last of these submissions had sought \$456 million in Australian Government funding to meet the full estimated cost of the ADP expansion. In the context of the global financial crisis, a series of SPBC meetings were held in April 2009 to consider funding for infrastructure projects, including funding for the ADP expansion proposal. On 28 April 2009, the SPBC approved grant funding of \$228 million, half the amount sought by the state. This commitment of NUWDP funding, and the earlier \$100 million grant, was announced via media release by the then Minister for Climate Change and Water on 12 May 2009 (Budget day).

11. A second Implementation Plan under the National Partnership Agreement on Water for the Future for the \$228 million in NUWDP funding was agreed by the Parliamentary Secretary for Sustainability and Urban Water and the Minister for Sustainability, Environment, Water, Population and Communities on 26 July 2011. The final payment under this Implementation Plan was made in December 2012.

Project status

12. Construction work on the ADP has been completed and, as mentioned above, all grant payments totalling \$328 million have been made. The completed facility has the capacity to supply up to 100GL of desalinated drinking water per year, thereby providing Adelaide with a climate independent source of water.

13. The ADP has been designed to operate flexibly, in conjunction with other water supply sources including the River Murray. The amount of water (if any) that the plant will produce is determined by SA Water. In this respect,

⁷ Each request referred to South Australia's submission to Infrastructure Australia.

on 4 October 2012, SA Water announced that improved inflows into the River Murray and Mount Lofty catchments had put it in a position where it could utilise these sources first. SA Water further announced that, to keep costs down for its customers, it was planning to use the lower cost water sources first, which meant placing the ADP in 'standby mode'.

Audit objectives, criteria and scope

14. The objective of the audit was to assess the awarding of funding for the construction of the ADP against the requirements of the Commonwealth's grants administration framework, which includes the Government's policy requirements for the approval of grants, with a particular focus on the assessments undertaken of each proposed grant in terms of the guidelines for the NUWDP; and identify any potential improvements in grants administration practices.

15. The audit followed a request from Senator Simon Birmingham, Liberal Senator for South Australia, Shadow Parliamentary Secretary for the Murray-Darling Basin and Shadow Parliamentary Secretary for the Environment, who had raised a number of concerns about the grants firstly through Senate Estimates and subsequently in correspondence to the Auditor-General.

16. The audit examined the first grant of \$100 million towards the 50GL per annum ADP, and the second grant of \$228 million towards the expanded 100GL per annum ADP. In respect to each grant, the audit examined the:

- assessment by relevant agencies of the merits of awarding Australian Government funding for the construction of the ADP project;
- provision of departmental advice to Ministers; and
- development of agreements signed in respect to the approved grant funding.

17. In particular, the two grants were examined in the context of key requirements of the financial management framework that:

- any proposal to spend public money, including a grant to meet an election commitment, only be approved if reasonable inquiries have been undertaken to allow the decision-maker to be satisfied that the proposal is an efficient, effective, economical and ethical use of public money, and that it is consistent with the program guidelines and any other relevant government policies; and

- grant funding decisions by Ministers be informed by agency advice on the merits of the proposal relative to the program guidelines.

18. As noted at paragraph 3, the decision to approve \$228 million in grant funding for an expanded ADP was made by the SPBC. This decision was informed by advice from central agencies.⁸ Accordingly, this report includes relevant references to the decision to award the grant, and the nature of the agency advice that informed this decision, given it is a key requirement of the financial framework that any decision to award grant funding draw upon agency advice as to the merits of the proposal in terms of the program guidelines. I have concluded that the inclusion of this limited information concerning the funding decision taken by the SPBC is not contrary to the public interest.⁹

Overall conclusion

19. Against the background of a review of grants administration commissioned by the Government¹⁰ that had expressed concerns that the administration of grant programs had been vulnerable to political manipulation and encouraged gaming by potential funding recipients, the Government agreed in December 2008 to implement a grants administration framework that would improve the performance, transparency and accountability of spending on grants.¹¹ Two key obligations of the enhanced grants administration framework (reinforcing requirements first introduced in December 2007) were that guidelines be developed for all new grant programs and that Ministers not approve a proposed grant without obtaining the benefits of agency advice on the merits of the proposal relative to the program guidelines.

20. A key recommendation of the Strategic Review accepted by the Government was that the grants assessment and decision-making requirements apply to all proposed grants, including those made in relation to

⁸ Advice specific to the ADP's expansion was provided by central agencies on two occasions, with particular input from the Department of Finance and Deregulation (Finance) and the Department of the Prime Minister and Cabinet (PM&C).

⁹ Section 37 of the *Auditor-General Act 1997* outlines the circumstances in which particular information is not to be included in public reports, including if the Auditor-General is of the opinion that disclosure of the information would be contrary to the public interest.

¹⁰ The Strategic Review of the Administration of Australian Government Grant Programs (Strategic Review).

¹¹ The Government decisions were made after considering the July 2008 report of the *Strategic Review of the Administration of Australian Government Grant Programs*, which had referenced ANAO audits of grant programs.

election announcements (such as the \$100 million ADP grant) and grant proposals that arise other than through a competitive call for applications (such as the \$228 million ADP grant). The Strategic Review concluded that the requirement for Ministers to receive agency advice on the merits of a proposed grant relative to the program guidelines was a 'prudent control'. Accordingly, the enhanced grants administration framework does not provide for exceptions to this requirement. Further, there was no specific decision taken by Government that the requirement for agency advice on the merits of grant proposals did not apply to the grant funding being considered for the ADP.

21. When considered against the program guidelines, neither of the ADP grants awarded under the NUWDP demonstrably satisfied the program merit criteria. Although the first grant (which related to the election commitment) was assessed against program criteria, the second grant was awarded through a truncated process that did not accord with the grants administration framework established by the Government, nor the NUWDP program guidelines.

22. By way of elaboration, the first ADP grant was awarded after the then Department of the Environment, Water, Heritage and the Arts (DEWHA) had obtained information from SA Water, assessed it against the eligibility and merit criteria included in the National Urban Water and Desalination Plan (NUWDP) program guidelines and provided advice to the then Minister for Climate Change and Water. This process accorded with the grants administration framework but there were shortcomings in the underlying assessment work and the resulting advice did not fully inform the Minister.¹² As a result, ANAO has made a recommendation to DSEWPaC concerning its assessment of grant proposals directed at promoting the achievement of value for money by: a high standard of assessment and advice being applied to all grant spending proposals, irrespective of whether they arise from a competitive process, relate to an election commitment or are another form of ad hoc grant; and providing Ministers with other options should they wish to

¹² Specifically, the department identified that the project would proceed without Australian Government funding, meaning that the third merit criterion relating to the cost-effectiveness of an Australian Government contribution (see paragraph 2) had not been met. However, in its brief to the Minister, the department advised that the proposal met all program criteria.

pursue funding for proposals that are not consistent with grant program guidelines.¹³

23. The shortcomings in respect to the second ADP grant are more significant. In particular, this grant was awarded through a process that was inconsistent in a number of respects with the requirements of the Government's grants administration framework.¹⁴ South Australia had originally sought funding for the ADP expansion proposal through Infrastructure Australia, as part of that entity's development of the first national Infrastructure Priority List. However, before the Infrastructure Australia process had been concluded, the then South Australian Premier made representations to the then Prime Minister in respect to the Infrastructure Australia funding submission for the ADP expansion project. Funding of the ADP expansion project through the NUWDP was considered after Infrastructure Australia concluded that the project had not demonstrated economic merit and, as a result, Ministers had been advised that the project was not eligible for funding from the Building Australia Fund.¹⁵ Nevertheless, the grant was subsequently approved by the Strategic Priorities and Budget Committee (SPBC) of Cabinet notwithstanding that:

- the NUWDP program guidelines did not allow for funding to be awarded for ad hoc grant proposals (a major projects funding round was open¹⁶, with applications to close on 30 June 2009 but with project funding capped at 10 per cent of estimated project costs to a maximum of \$100 million);

¹³ In this respect, the Strategic Review of Grants observed that: 'The statutory obligations applying to the approval of spending proposals deriving from election commitments are no different from those attaching to the approval of any other spending proposal; accordingly, departments should provide their Ministers with advice on options for the funding of election commitments, having regard both to a Minister's statutory obligations and the extent to which the spending proposals satisfy the eligibility or assessment criteria for grant programs which might be used to fund the commitments.'

¹⁴ In requesting this audit, Senator Birmingham had outlined that, despite questioning through the Senate Estimates process, he had been unable to establish how the request for the second grant had been made, what assessment of its merits had been undertaken or how the decision to award the grant had been taken.

¹⁵ The BAF evaluation criterion not met related to a proposal demonstrating, through a thorough cost-benefit analysis, that it represents good value for money. This criterion was closely aligned with the published methodology for compiling the Infrastructure Priority List, which had outlined that objective cost-benefit analysis (through Benefit Cost Ratios, BCRs) would be used as the 'primary driver' of decision-making (and Infrastructure Australia had assessed that the BCR for the ADP expansion proposal was too low to support being included on the Infrastructure Priority List). Similarly, the second NUWDP merit criterion was 'cost-effectiveness of the project' with the program guidelines stating that, in terms of this criterion, proposals should include cost-benefit analysis.

¹⁶ A funding condition was adopted after the SPBC approval of the grant requiring that the expanded ADP provide environmental benefits but obtaining an acceptable proposal from South Australia was challenging for a number of reasons including that the funding was not awarded through a competitive process. A competitive funding process provides an incentive for project proponents to offer maximum benefits in return for an Australian Government funding contribution in order for their grant proposal to be ranked more highly than other competing proposals, noting that one of the NUWDP merit criteria related to environmental benefits.

- the May 2008 Budget Papers had stated that funding should only be provided to public infrastructure projects that meet a minimum benchmark social rate of return, determined through rigorous cost-benefit analysis, with Infrastructure Australia identifying that the ADP expansion proposal did not pass this test (which was a requirement of the Infrastructure Australia assessment methodology); and
- no agency had undertaken an assessment of the ADP expansion proposal against the NUWDP program guidelines.

24. Neither the department nor its then Minister became aware of the funding decision until more than one week after it had been taken. The only advice provided to Ministers in respect to funding of the ADP expansion proposal through the NUWDP was from central agencies, an approach that would generally not be viewed as conducive to good government given the role usually expected of portfolio agencies in advising Ministers on spending proposals being considered in relation to programs they administer.¹⁷

25. The central agency advice did not recommend that NUWDP funding be awarded (as neither central agency had assessed the merits of the proposal in terms of the program guidelines) but, rather, supported further consideration of funding the expanded ADP under the NUWDP. This advice did not remind Ministers that, since December 2007, the grants administration framework has required that a decision to award grant funding was not to be made until after an agency had assessed its merits in terms of the program guidelines; notwithstanding that the Department of Finance and Deregulation, which is the agency responsible for the implementation of the enhanced grants administration framework, was one of the central agencies involved in providing the advice.

26. A recurring theme in ANAO's audits of grants administration over a number of years has been the importance of grant programs being implemented in a manner that accords with published program guidelines. Similarly, the grants administration framework was developed based, in part,

¹⁷ In March 2013, the Department of Finance and Deregulation advised ANAO that it agreed that agency advice should be provided on the merit of a proposed grant, relative to the relevant grant program guidelines, before a funding decision is taken but that central agencies do not have 'the same capacity or access to information that is required to evaluate a grant proposal against the relevant program guidelines' and that 'it would be inappropriate and inconsistent with the Administrative Arrangements Orders for central agencies to take on the role of a line-agency in an area for which a line-Minister is responsible'.

on a recognition that potential applicants and other stakeholders have a right to expect that program funding decisions will be made in a manner, and on a basis, consistent with the published program guidelines. Accordingly, where a proposal is inconsistent with the guidelines for a particular grant program, it is important that Ministers receive sound advice to this effect from their departments. In situations where Ministers may still be disposed to fund such proposals because they are seen as potentially an efficient and effective use of public money, alternative approaches should be considered such as seeking to improve the value proposition from the Commonwealth's perspective (where envisaged by the guidelines), publishing amended program guidelines or establishing a new program or funding source.

Key findings by chapter

Grant Awarded for the 50 Gigalitre (per annum) Desalination Plant

27. To enable an assessment to be undertaken against the published NUWDP eligibility and merit criteria¹⁸, DEWHA obtained from SA Water a funding application together with a range of supporting material. DEWHA assessed the grant proposal as meeting the program guidelines and recommended that the then Minister for Climate Change and Water approve funding of \$100 million under the NUWDP for a 50GL per annum ADP. The Minister agreed to this recommendation.

28. The evidence supports DEWHA's assessment that the application met the NUWDP's eligibility criteria. However, the basis for DEWHA concluding that the merit criterion 'cost-effectiveness of the Australian Government contribution' (see paragraph 2) had been met was not consistently set out in the assessment records and associated briefing provided to the Minister. Specifically, the assessment record stated that DEWHA had identified that the project would proceed without Commonwealth funding and there was no specific additional outcome from any Australian Government funding. Nevertheless, the department's assessment record outlined that this merit

¹⁸ Selection criteria form the key link between the program's stated objectives and the outcomes that are expected to be achieved from the funding provided, and fall into two main groups, as follows:

- eligibility criteria are the criteria that an application must satisfy in order to be considered for funding; and
- merit (or assessment) criteria are the criteria against which all eligible, compliant applications will be assessed in order to determine their merits against the program objectives and, for competitive programs, other competing applications.

criterion could be considered met as making a financial contribution to the project was consistent with an election commitment.

29. Notwithstanding the comments stated in DEWHA's assessment against merit criterion three, the department included a separate comment in its covering briefing noting that NUWDP funding would result in a small reduction in cost increases for water users.¹⁹ In April 2013, DSEWPaC advised ANAO that the reduced cost to water users was the basis on which the third merit criterion had been met. This situation emphasises the importance of assessment records and associated briefings clearly and consistently reflecting the basis for assessment conclusions.

30. A factor not effectively addressed by DEWHA in its assessment of the grant proposal related to the amount of water the ADP was expected to contribute to Adelaide's water supply. The flexible operational model adopted for the ADP was intended to allow a high degree of control over how much water the plant produces, which in turn was to provide flexibility to shut down the plant or reduce production when 'cheaper' water supplies are available or storages are sufficiently full. However, this situation was not addressed in DEWHA's assessment of the application against two merit criteria, namely:

- the level of contribution to enhancing water supply. Reflecting the contents of the application submitted by SA Water, DEWHA advised the then Minister that a plant with a 50GL per annum capacity would be able to provide more than one quarter of Adelaide's water needs in a 'normal' year and up to 32 per cent during a drought year. These figures were premised on the plant operating at full capacity each and every year. In this respect, the drought year figure was consistent with the intended use of the plant during periods of reduced inflows (as had been recommended by the state's Desalination Working Group), thereby providing water security/insurance during such periods. However, the 'normal' years figure drawn by DEWHA from SA Water's funding application (see Figure 2.1 at page 47) overstated the contribution the ADP was expected to make to Adelaide's water supply as it was intended that the ADP would only be used when cheaper

¹⁹ Costs were to be recovered over time from users, with the application indicating that a \$100 million grant would reduce by 0.6 per cent (from 17.5 per cent to 16.9 per cent) the annual price increase. The program guidelines had included a reduction in the cost of water to end users as an example of an additional outcome from NUWDP funding that would be considered to demonstrate merit against the 'cost-effectiveness of the Australian Government contribution' merit criterion.

water sources were not available (see further at paragraph 13) which was not expected to be the case in average years; and

- the cost-effectiveness of the project. The assumption that the plant would operate at maximum capacity each year meant that the cost of water to be produced was understated in the funding application.²⁰ Further, the assessment advice provided by DEWHA to the then Minister made no reference to the cost of water that would be produced, notwithstanding that the published guidelines had indicated that this was a key measure of project cost-effectiveness, and that data on the cost of water had been included by SA Water in its funding application.

31. DEWHA's assessment in terms of the project cost-effectiveness criterion was also limited in scope, as it focused on whether construction of a desalination plant was more cost effective than an alternative approach of purchasing high security water entitlements. This was notwithstanding that the May 2008 Budget Papers had emphasised the importance of Benefit Cost Ratios (BCRs) to informing Government decision-making on public infrastructure projects, and the published NUWDP program guidelines had similarly stated that assessments against the project cost-effectiveness criterion would consider a project's BCR. The SA Water application had included information on BCRs for the project based on various assumptions²¹, but the methodology and assumptions used were not critically examined by DEWHA, and a BCR for the project was not referenced in the assessment advice provided to the then Minister.

Grant to Increase Plant Capacity to 100 Gigalitres (per annum)

32. The merits of the ADP expansion project were considered by Infrastructure Australia, which examined in detail a submission from South Australia that the project be funded from the Building Australia Fund.²²

²⁰ Desalination plants involve high fixed costs and significant, fixed, unavoidable operating costs such that the cost per kilolitre of water is greater in scenarios where the plant is not operated at full capacity.

²¹ BCRs calculated by SA Water drawing on the work of the state's Desalination Working Group, indicated that the project was not cost-effective (with a BCR less than 1.0).

²² ANAO has previously concluded that Infrastructure Australia's methodology provided a 'robust framework' for the development of infrastructure priority lists, and that 'a clear strength in the process employed in developing the first Infrastructure Priority List was the rigorous approach adopted to analysing proponent submissions against the published criteria'. See ANAO Audit Report No.2 2010–11, *Conduct by Infrastructure Australia of the First National Infrastructure Audit and Development of the Infrastructure Priority List*, Canberra, 23 July 2010, pp. 20 – 23.

Infrastructure Australia concluded that the project was not supported by robust cost-benefit analysis and, in any event, the BCR calculated for the project was too low such that it did not offer a net economic benefit. Accordingly, Infrastructure Australia did not include the project on its first Infrastructure Priority List, and the ADP expansion proposal was not eligible for funding from the Building Australia Fund.

33. In April 2009, the ADP expansion project was awarded funding from the NUWDP. However, the process by which approval was given for the grant of \$228 million to increase the capacity of the ADP from 50GL per annum to 100GL per annum did not accord with an important aspect of the grants administration framework. Specifically, since December 2007, there has been a requirement that Ministers not approve a proposed grant without first receiving agency advice on its merits relative to the guidelines for the program. However:

- DSEWPac has advised ANAO that it was unaware of an intention for the project to be funded under the NUWDP and, as a result, the department did not assess the proposal for Australian Government funding towards an expanded ADP against the NUWDP program guidelines before Ministers decided to award the \$228 million grant; and
- advice to Ministers on the proposal was provided by central agencies. The advice indicated that the proposal was not supported by a full business case, the quality of the costings was low and the Commonwealth's exposure to project risk was high. Central agencies supported further consideration of funding the expanded ADP under the NUWDP, but the central agencies did not assess the merits of the proposal in terms of the program guidelines.²³

34. DEWHA became aware of the decision to award NUWDP funding towards an expanded ADP some days after the decision was taken. In a subsequent briefing to its then Minister, the department referred the Minister to its earlier assessment that a \$100 million grant towards a 50GL per annum ADP satisfied the NUWDP criteria, and advised that the 'expanded plant would also meet these criteria' and also suggested that the decision to award funding be explained, in part, by the then Minister stating that the proposal

²³ Central agencies were aware of the program eligibility and merit criteria.

had been assessed outside the NUWDP competitive process but against the program criteria. However, DEWHA had not obtained the information from South Australia that would be necessary to assess the 100GL per annum ADP proposal in terms of the NUWDP program criteria, and had not examined the expansion project against the NUWDP program guidelines. The department's advice as to how to explain the decision to award funding was not sound, noting that:

- the awarding of further funding to the ADP was inconsistent with the competitive bidding process outlined in the NUWDP program guidelines. The only exceptions to this process requirement related to five named election commitment projects which had been the subject of a specific government decision that they be progressed through the NUWDP. The first \$100 million grant to the ADP had satisfied the election commitment in respect to the Australian Government making a financial contribution to a desalination plant for Adelaide. Under the published program guidelines²⁴, any further grant required consideration in the context of the competitive major projects funding round that was underway at the time the South Australian Government approached the then Prime Minister seeking funding for the expansion project;
- the size of the grant (\$228 million, representing 50 per cent of the estimated project costs) was significantly greater than permitted under the program guidelines (which limited NUWDP funding contributions to 10 per cent of eligible capital costs, to a maximum of \$100 million); and
- the grant proposal did not demonstrably satisfy three of the five merit assessment criteria. Specifically:
 - constructing a 100GL per annum ADP provided increased water security/insurance compared with that provided by a 50GL per annum plant. However, in respect to the first of the NUWDP's merit criteria relating to water supply security (see paragraph 2), information provided to DEWHA in relation to

²⁴ ANAO's grants administration Better Practice Guide notes that departing from the selection process and/or criteria outlined in the published guidelines may be detrimental to the conduct of a transparent and equitable grant program. Further in this respect, the Commonwealth Grant Guidelines advise that, in the interests of transparency, accountability and equity, the program guidelines should document any circumstances in which it might be considered necessary to waive or amend the eligibility or assessment criteria established for a granting activity.

the \$100 million grant proposal had outlined that the ADP expansion was expected to provide increased insurance in terms of long-term (between 2025 and 2050) water security but water from an expanded plant was not expected to be needed in the short-term²⁵ either in average years or drought years;

- based on Infrastructure Australia’s analysis²⁶, the project was not cost-effective, meaning the project did not meet the second merit criterion; and
- in respect to the third merit criterion relating to the cost-effectiveness of an Australian Government contribution (see paragraph 2), the evidence is that the 100GL expansion project was proceeding irrespective of whether Australian Government funding was awarded and, in seeking funding, South Australia did not offer to commit to provide any environmental benefits in return for Australian Government funding of the proposal.²⁷

35. In response to a number of ANAO performance audit reports that have noted continuing shortcomings in adherence to the requirement for spending decisions to be informed by agency advice on the merits of proposed grants relative to the program guidelines, updated Commonwealth Grant Guidelines (CGGs) (to take effect from 1 June 2013) will introduce more specific briefing requirements. These requirements seek to improve the information provided to Ministers and consistency in briefing practices across government. Among other matters, the updated CGGs state that an agency is required, as a minimum to:

- explicitly note that the spending proposal being considered is a ‘grant’;

²⁵ SA Water’s application for funding towards the 50GL per annum plant advised that a plant with this capacity was expected to reduce the risk of level 5 water restrictions from a 1 in 45 year chance without a 50GL per annum ADP to 1 in 230 years with a 50 GL per annum ADP.

²⁶ See footnote 15.

²⁷ However, both before and after funding was approved, DEWHA had suggested that South Australia should be required to provide environmental water as part of the conditions of the grant. Accordingly, the announcement of the grant included a statement that funding would be provided on the basis that the expanded project would deliver improved water security for Adelaide and a reduced reliance on the Murray River, along with environmental benefits. In this respect, the NUWDP program guidelines included a merit criterion titled ‘environmental benefits’, with the guidelines outlining that proposals for NUWDP funding should describe ‘for projects that generate water savings for environmental flows, how they intend to preserve and manage those flows over the long term’.

- provide information on the applicable requirements of the FMA Act and Regulations, the CCGs (particularly any ministerial reporting obligations), including the legal authority for the grant;
- outline the application and selection processes, including the selection criteria, that were used; and
- include the merits of the proposed grant or grants relative to the grant guidelines and the 'key consideration' of achieving value with public money.

Grant management arrangements

36. The program guidelines required that NUWDP grants be governed by a legally enforceable funding agreement, and DEWHA initially sought to develop a funding agreement with SA Water. However, as it eventuated, the two ADP grants are governed by Implementation Plans under the Water for the Future National Partnership Agreement. The change in approach occurred as a result of a misunderstanding of the new Federal Financial Relations Framework at the time it was being introduced. Among other adverse effects, the decision to adopt Implementation Plans under a National Partnership Agreement contributed to delays in the finalisation of governance arrangements for the grant funding (the Implementation Plans were not agreed until February 2010, for the \$100 million grant, and July 2011, for the \$228 million grant).

37. However, the most significant factor in the delay in finalising the governance arrangements for the \$228 million grant related to South Australia meeting the funding condition adopted after the SPBC approval of the grant, which required that the expanded ADP provide environmental benefits. Considerable effort was made by senior DEWHA (and, subsequently, DSEWPaC) officials as well as at ministerial level to obtain a proposal from South Australia that would meet the funding condition. Obtaining an acceptable proposal from South Australia was challenging given that the following circumstances placed the Commonwealth in a difficult negotiating position:

- funding was obtained by South Australia other than through a competitive funding round (a process that can provide an incentive for project proponents to offer maximum benefits in return for an Australian Government funding contribution in order for their grant proposal to be ranked more highly than other competing proposals);

- the South Australian Government had not offered to commit to reducing its draw on the Murray River when seeking Australian Government funding for the expansion project; and
- the amount and nature of the environmental benefits expected was not discussed or agreed with South Australia prior to funding being awarded, and the funding condition did not require a specific level of water savings to be provided.

Agency responses

38. The proposed audit report issued under section 19 of the *Auditor-General Act 1997* was provided to DSEWPaC, Finance and PM&C as well as the Prime Minister and Minister for Climate Change and Water at the time the grants were awarded, the Parliamentary Secretary for Sustainability and Urban Water who approved the Implementation Plan for the second grant and the Minister for Sustainability, Environment, Water, Population and Communities. A formal response to the draft report was provided by DSEWPaC and Finance.

Department of Sustainability, Environment, Water, Population and Communities

39. DSEWPaC's response is provided below.

The Department of Sustainability, Environment, Water, Population and Communities agrees with the recommendation of the audit report (Recommendation 1).

The Government's decisions to provide funding for the Adelaide Desalination Plant reflected judgements, at a time of unprecedented drought, about the level of risk to Adelaide's future water supply that would be acceptable to the community. These judgements informed the Government's decision about the consequent Commonwealth financial contribution. Such judgements are properly matters for Ministers to determine.

In advising the Government, the department was cognisant of the fact that funding for the Adelaide Desalination Plant was a specific election commitment. The guidelines for the National Urban Water and Desalination Plan explicitly provided for funding related to the election commitment to be determined outside the general competitive grant funding round. As required, the department undertook an assessment against the criteria in the guidelines. The department acknowledges the findings of the report in relation to the

documented assessment process by the department for the first tranche of funding.

In advising on the second tranche of funding, the department's advice was informed by its earlier assessment of the first tranche, which, as noted above, had been conducted against the criteria in the guidelines. As indicated in the Audit report, a further substantive evaluation of the second tranche of funding against the criteria was not undertaken.

The department agrees with the audit recommendation and is committed to continuous improvement in grants administration processes. This has included implementation of a Grants Administration Framework in June 2011 and establishment of the Portfolio Project Management Office in May 2012.

Department of Finance and Deregulation

40. The Department of Finance and Deregulation's response is provided below.

The Australian Government's grants policy framework has evolved significantly over recent years, from December 2008 when the Government agreed to implement a new grants administration framework in response to the Strategic Review of The Administration of Australian Government Grant Programs (Strategic Review), to the more recently enhanced and updated Commonwealth Grant Guidelines (CGGs) (with updates to take effect on 1 June 2013).

In advising on the development of the grants policy framework, Finance has been committed to supporting sound grants management practices and to accountability and transparency in grants administration and decision making. In response to the Government's decisions following the Strategic Review, Finance implemented the CGGs in July 2009 which sought to improve transparency and accountability and introduce rigour and common processes around government granting activity. The most recent changes to the CGGs have been in response to continuing issues in grants administration practices, which have been highlighted, particularly by the ANAO.

In particular, Finance notes that the grants administration arrangements that applied at the time of the National Urban Water and Desalination Plan and the Adelaide Desalination Plant grants, which are relevant for this audit, relate to interim arrangements introduced in January 2009 and not to the CGGs themselves (which took effect in July 2009). The interim arrangements reflect the Government's decision to implement a new grants administration framework provided general policy guidance in relation to grant approval and reporting processes, whereas the CGGs introduced mandatory requirements from July 2009.

Recommendation

Recommendation No. 1

Paragraph 2.61

For grant spending proposals that result from election commitments or arise other than through a competitive process, ANAO recommends that the Department of Sustainability, Environment, Water, Population and Communities promote the achievement of value for money by:

- (a) clearly informing decision-makers about the extent to which a proposal meets the program assessment criteria;
- (b) applying cost-benefit analysis as a key input to its advice on decisions about whether to provide Australian Government funding towards public infrastructure projects; and
- (c) providing Ministers with other options should they wish to pursue funding for proposals that are not consistent with the guidelines for the relevant grant program.

DSEWPAC response: *Agreed*

Finance response: *Agreed in principle*

Audit Findings

1. Introduction

This chapter provides an overview of the election commitment relating to the National Urban Water and Desalination Plan and key provisions relating to the grants for the Adelaide Desalination Plant. It also sets out the audit objective, scope and criteria.

Background

1.1 During election campaigns political parties release policy statements and the parties or their candidates may make announcements of their intention to provide certain benefits, services or facilities in the event the relevant party is elected or re-elected to government.²⁸ The approach generally adopted at the Commonwealth level is that the incoming government confirms which announcements made during the campaign represent an election commitment, with relevant portfolio Ministers and departments being allocated responsibility for progressing the delivery of the confirmed announcements.²⁹

1.2 Commonwealth grants, including those made to fulfil an election commitment, involve the expenditure of public money and are subject to applicable financial management legislation. Specifically, the *Financial Management and Accountability Act 1997* (FMA Act) provides a framework for the proper management of public money. In addition, an enhanced grants administration framework was progressively introduced starting in December 2007 and culminating in amendments to the FMA Regulations and the issuing of the Commonwealth Grant Guidelines (CGGs), both of which took effect from 1 July 2009.³⁰

1.3 In this context, and as previously noted by the ANAO³¹ and as reflected in the Strategic Review of the Administration of Australian Government Grant Programs (the Strategic Review)³², it is important to balance the expectation of

²⁸ ANAO Better Practice Guide, *Implementing Better Practice Grants Administration*, Canberra, June 2010, p. 54.

²⁹ Ibid.

³⁰ Updated CGGs are to take effect from 1 June 2013. Among other matters, the updated CGGs build upon the existing requirement that Ministers must not approve a grant before receiving agency advice on the merits of the proposed grant by introducing more specific briefing requirements with the objective of improving the information provided to Ministers as well as consistency in briefing practices across agencies.

³¹ See, for example, ANAO Audit Report No. 24 2010–11, *The Design and Administration of the Better Regions Program*, Canberra, 27 January 2011. At the time this audit report was tabled, four election commitment projects allocated to the program had not proceeded to having a funding agreement signed and consideration had or was being given to withdrawing the offer of funding.

³² The review was commissioned by the Australian Government with the stated objective of improving efficiency, effectiveness, accountability and transparency in the administration of grant programs across the Commonwealth.

governments seeking to deliver upon their election commitments with the legislative obligations that:

- the decision-maker obtain and consider sufficient information to inform an assessment that it would be efficient, effective, economical and ethical (and not inconsistent with relevant government policies) to approve the spending of public money on a grant. Where this test is not met, the *Financial Management and Accountability Regulations 1997* (FMA Regulations) require that approval not be given to spend public money³³; and
- a record be made of the terms of the approval and (since 1 July 2009) the basis upon which the approver was satisfied that a proposed grant represented the proper use of public money.

1.4 In addition to these obligations, since December 2007, there has been a requirement that Ministers not approve a proposed grant without first receiving agency advice on its merits relative to the guidelines for the program. These requirements, and other related enhancements to the grants administration framework, are designed to assist Ministers to be appropriately informed when deciding whether to approve grants and to enhance accountability for those decisions.

Adelaide Desalination Plant election announcement

1.5 On 28 October 2007, in response to prolonged drought conditions at that time, the then Opposition announced that a Labor Government would implement a \$1 billion National Urban Water and Desalination Plan (NUWDP) to help secure the water supplies of Australia's major cities.³⁴ The NUWDP was outlined in the election policy document *Labor's national plan to tackle the water crisis*. That document also included a number of other announcements, including an unquantified commitment to provide funding towards the construction of a desalination plant for Adelaide. The specific commitment to this project was:

To assist Adelaide to diversify its water supply and reduce its reliance on the Murray. If South Australia proceeds with a desalination plant for Adelaide

³³ See further at paragraph 1.13.

³⁴ Kevin Rudd and Anthony Albanese, *Federal Labor's \$1 Billion National Urban Water and Desalination Plan*, Media Statement, 28 October 2007.

then, once a site is determined, a Rudd Labor Government will be a financial partner in a carbon neutral desalination plant for Adelaide.

1.6 The election policy announcement indicated that any financial contribution towards the construction of the Adelaide Desalination Plant (ADP) would draw on funds for investing in water infrastructure in the Murray Darling Basin. However, on 28 April 2008 as part of the 2008–09 Budget process, when agreeing to \$1 billion of funding over six years for the NUWDP, Ministers decided that five election commitments, including the ADP, should be funded from within the NUWDP. This approach also represented a change for the NUWDP, as the election announcement had been that all program funding would be open to applications.³⁵ It was further decided that any use of NUWDP funds to make a financial contribution to the ADP was ‘subject to a proposal from the South Australian Government, which meets the program criteria’.

1.7 On 14 August 2008, the then Prime Minister announced that, if the South Australian Government decided to expand the capacity of the ADP to 80 or 100GL per annum, the Australian Government would be prepared to co-invest with the state up to \$100 million to accommodate the expansion.³⁶

Implementation of the National Urban Water and Desalination Plan program

Program funding

1.8 The original \$1 billion NUWDP budget has been reduced over time to \$690 million.³⁷ The use of NUWDP funding for certain 2007 election commitment projects was explicitly recognised in program guidelines published in December 2008. Specifically, the program guidelines stated that funding already committed under that program included \$90.2 million for four projects that were election commitments as well as an unspecified amount of

³⁵ The 28 October 2007 announcement that a Labor government would implement a \$1 billion NUWDP together with the related election policy document *Labor's national plan to tackle the water crisis* stated that, to achieve value for money the private sector, local government and state governments would be able to submit proposals for funding assistance to Infrastructure Australia over an 18 month period to the end of June 2009.

³⁶ Prime Minister of Australia, *Joint Press Conference with South Australian Premier, Mike Rann and Minister for Climate Change and Water, Penny Wong*, Adelaide, 14 August 2008.

³⁷ The largest reductions were announced in each of the 2010, 2011 and 2012 Budgets (\$181.49 million in total, involving reduced program funding of \$131.19 million for 2011–12 and \$50.3 million for 2012–13) as well as a further \$50 million saving announced in the 2010 election period (to occur over three financial years) and another \$50 million reduction announced in the 2011–12 Mid-Year Economic and Fiscal Outlook.

funding for the ADP. As it eventuated, a total of \$328 million³⁸ was awarded through two grants for the construction of the ADP:

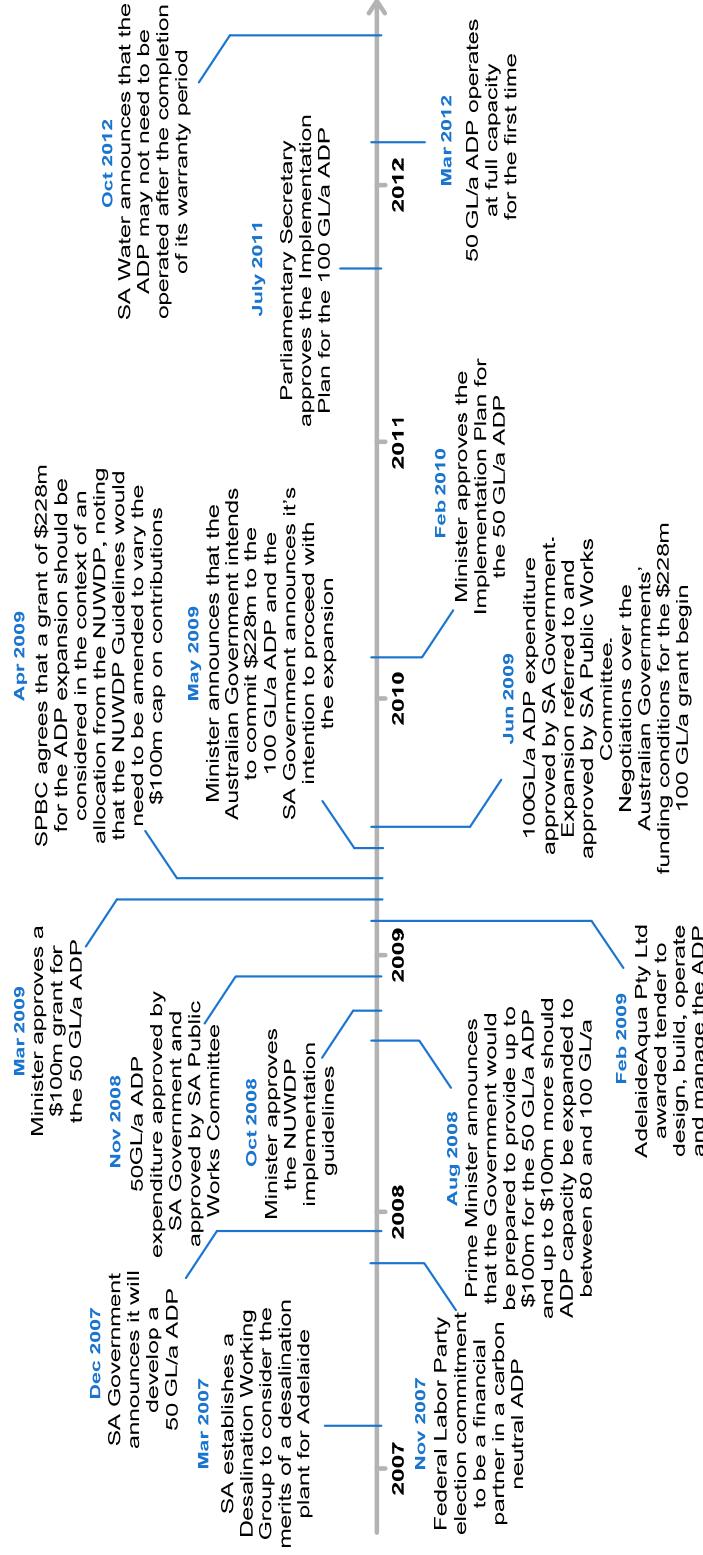
- in March 2009, the then Minister for Climate Change and Water approved \$100 million to support the construction of a 50 gigalitre (GL) per year desalination plant in Adelaide. The total value of this project was estimated to be \$1.374 billion; and
- shortly thereafter, in the context of the May 2009 Budget, the Strategic Priorities and Budget Committee (SPBC) of Cabinet decided that a further grant of \$228 million should be awarded towards the estimated \$456 million cost of expanding the capacity of the ADP to 100GL per annum.

1.9 In addition to the election commitment projects, four competitive funding rounds have been held comprising: a round for major projects and three rounds for stormwater harvesting and reuse projects. Figure 1.1 outlines the key milestones in the award of grant funding.

³⁸ By 7 December 2012, all of the \$328 million in grant funding had been paid to South Australia.

Figure 1.1

Key milestones in the award of grant funding



Source: ANAO analysis.

Program guidelines

1.10 As has been noted in a number of ANAO performance audit reports as well as ANAO's grants administration Better Practice Guide, program guidelines play a central role in the conduct of effective, efficient and accountable grants administration. To improve the design and administration of grant programs, since December 2007 a key obligation under the enhanced grants policy framework is for all grant programs to have guidelines in place. Reflecting their importance, the guidelines for each program represent one of the policy requirements that proposed grants must be consistent with in order to be approved for funding in accordance with FMA Regulation 9, which sets out the principal obligation applying to the approval of all spending proposals.³⁹

1.11 Guidelines for the NUWDP were issued in December 2008, after the Government had decided that the ADP and four other election commitments would be allocated to the NUWDP and the announcement that it would be prepared to co-invest with the state up to \$100 million to accommodate an expanded plan (see paragraphs 1.6 and 1.7). The guidelines outlined that the objective of the NUWDP is to support major desalination, water recycling and stormwater harvesting projects that contribute significantly to achieving the aim of improving security of water supplies to Australia's cities, without adding to greenhouse gas emissions. In the context of an ANAO audit of the development and approval of grant program guidelines, DSEWPaC advised ANAO that these guidelines 'cover the program generally'. They were the guidelines relevant to the ADP as well as a competitive funding round for major projects (those with eligible capital costs of at least \$30 million) that opened to applications in December 2008.⁴⁰

³⁹ Specifically, an approver is required to make reasonable inquiries in order to be satisfied that a proposal would be a proper use of Commonwealth resources and would not be inconsistent with the policies of the Commonwealth. One policy of the Commonwealth is the guidelines applying to the particular grant program.

⁴⁰ Separate guidelines were later developed in respect to the:

- \$300 million of NUWDP funding set aside for stormwater harvesting and reuse projects through three competitive funding rounds. Guidelines were issued in March 2009 for the first two funding rounds with another set of guidelines released in June 2011 after the Government decided to conduct a third funding round; and
- implementation of the election commitments to establish a centre of excellence in desalination in Perth and establish a centre of excellence in water recycling in Brisbane. Neither election commitment specified which entity would establish the centre of excellence, and separate sets of guidelines were issued in November 2008 to govern the selection of an administering organisation for each centre.

Eligibility and merit criteria

1.12 Selection criteria form the key link between the program's stated objectives and the outcomes that are expected to be achieved from the funding provided. Selection criteria fall into two main groups, as follows:

- threshold criteria are the criteria that an application must satisfy in order to be considered for funding. These are also variously expressed as 'eligibility criteria', 'mandatory criteria', 'compliance criteria' or 'gateway criteria'; and
- assessment criteria are the criteria against which all eligible, compliant applications will be assessed in order to determine their merits against the program objectives and, for competitive programs, other competing applications.

1.13 The NUWDP guidelines included program eligibility and merit assessment criteria. As outlined in Table 1.1, this comprised 11 eligibility criteria (four relating to the proponent and seven to the project) and five merit criteria⁴¹, which reflected the program objectives. In this respect, and consistent with the April 2008 Government decision referred to at paragraph 1.6, the published program guidelines had outlined that the election commitment was required to meet the program criteria in order to be approved for funding. Even without this specific requirement, an assessment against the program guidelines (including published criteria) is necessary to support the required advice to the decision-makers as to whether providing a grant represents efficient, effective, economical and ethical use of public money (in terms of FMA Regulation 9).⁴²

⁴¹ The guidelines also included an attachment titled 'Explanatory Notes for Application Preparation' and stated that applications for NUWDP assistance 'should be consistent with' these explanatory notes.

⁴² ANAO Audit Report No. 24 2010–11, *The Design and Administration of the Better Regions Program*, Canberra, 27 January 2011, pp. 79–80.

Table 1.1**Published NUWDP selection criteria**

Eligibility criteria	
Proponent	Project
1. Must be a body incorporated in Australia, including a statutory corporation, a body corporate, or a corporation sole (project proposals submitted by consortia will be considered only if they identify a lead proponent with whom the funding agreement is to be entered).	1. Must use desalination, and/or recycling and/or stormwater harvesting to make a significant contribution to water security.
2. Must accept the terms and conditions of the standard funding agreement.	2. Must provide water to urban populations of at least 50 000 people.
3. Must demonstrate a capacity to deliver the proposed project on time and on budget.	3. Must be technically sound and able to deliver the identified outcomes with a high degree of certainty.
4. Must be financially viable and compliant with their taxation responsibilities.	4. Must have eligible capital costs of at least \$30 million.
	5. Must be financially viable once completed with no further call on the Australian Government for ongoing funding.
	6. Must be completed by 30 June 2014.
	7. Must source 100 per cent of its energy needs from renewable sources or fully offset the carbon impact of the project's operations.
Merit criteria	
1. Level of contribution to enhancing water supply security within the targeted urban area.	
2. Cost-effectiveness of the project.	
3. Cost-effectiveness of the Australian Government contribution.	
4. Demonstrable evidence that the proposed project is a key strategic element of the preferred long-term water supply plan for the area.	
5. Extent of environmental benefits and/or environmental best practice initiatives.	

Source: NUWDP Implementation Guidelines, December 2008, p. 4.

Program administration responsibilities

1.14 In the context of the 2007 election, the Australian Labor Party reiterated an intention first outlined in 2005 to establish Infrastructure Australia as an independent statutory authority to assist in the planning and coordination of Australia's infrastructure needs. The election policy document *Labor's national plan to tackle the water crisis* had stated that Infrastructure Australia would

undertake an independent cost-benefit assessment of all proposals for NUWDP funding.

1.15 The Infrastructure Australia Bill was introduced in the Parliament on 21 February 2008, passed both Houses of Parliament in March 2008, and the Act commenced on 9 April 2008.⁴³ However, following the election, responsibility for administering the NUWDP was allocated to the then Department of the Environment, Water, Heritage and the Arts (DEWHA) rather than Infrastructure Australia.⁴⁴ In September 2010, DEWHA became the Department of Sustainability, Environment, Water, Population and Communities (DSEWPaC).⁴⁵

Audit objective, scope and criteria

1.16 The objective of the audit was to assess the awarding of funding for the construction of the ADP against the requirements of the Commonwealth's grants administration framework, which includes the Government's policy requirements for the approval of grants, with a particular focus on the assessments undertaken of each proposed grant in terms of the guidelines for the NUWDP; and identify any potential improvements in grants administration practices.

1.17 The audit followed a request from Senator Simon Birmingham, Liberal Senator for South Australia and Shadow Parliamentary Secretary for the Murray-Darling Basin and Shadow Parliamentary Secretary for the Environment who had initially raised a number of concerns about the grants through Senate Estimates and, subsequently, in correspondence to the Auditor-General.

1.18 As noted at paragraph 1.8, the decision to approve \$228 million in grant funding for an expanded ADP was made by the SPBC. This decision was informed by advice from central agencies. Accordingly, this report includes relevant references to the decision to award the grant, and the nature of the

⁴³ Subsequently, the May 2008 Budget included \$20 million over four years to fund the Office of the Infrastructure Coordinator.

⁴⁴ Nevertheless, South Australia sought funding for the expansion of the ADP from 50GL per annum to 100GL per annum (together with two related water infrastructure projects) as part of the first national infrastructure audit and development of Infrastructure Australia's first infrastructure priority list (see ANAO Audit Report No.2 2010–11, *Conduct by Infrastructure Australia of the First National Infrastructure Audit and Development of the Infrastructure Priority List*, Canberra, 23 July 2010). That proposal was not included on the May 2009 Infrastructure Priority List.

⁴⁵ Throughout this report, the department responsible for administering the NUWDP at the relevant point in time is referred to as the DEWHA or DSEWPaC, as appropriate.

agency advice that informed this decision, given it is a key requirement of the financial framework that any decision to award grant funding draw upon agency advice as to the merits of the proposal in terms of the program guidelines. I have concluded that the inclusion of this limited information concerning the funding decision taken by the SPBC is not contrary to the public interest⁴⁶

Audit scope and criteria

1.19 The audit examined the first grant of \$100 million towards the 50GL per annum ADP, and the second grant of \$228 million towards the expanded 100GL per annum ADP. In respect to each grant, the audit examined the:

- assessment by relevant agencies of the merits of awarding Australian Government funding for the construction of the ADP project, including environmental benefits;
- provision of departmental advice to Ministers; and
- agreements signed in respect to the approved grant funding.

1.20 The audit was conducted in accordance with ANAO auditing standards at a cost to the ANAO of \$295 000.

⁴⁶ Section 37 of the *Auditor-General Act 1997* outlines the circumstances in which particular information is not to be included in public reports, including if the Auditor-General is of the opinion that disclosure of the information would be contrary to the public interest.

Report structure

1.21 The structure of the report is outlined in Table 1.2.

Table 1.2

Report structure

Chapter	Overview
2. Grant Awarded for 50 Gigalitre (per annum) Desalination Plant	Examines the departmental assessment of the application submitted by the South Australian government for a \$100 million grant under the NUWDP to construct a 50GL per annum Adelaide Desalination Plant, and the resulting advice provided to the then Minister that the grant be awarded.
3. Grant to Increase Plant Capacity to 100 Gigalitres (per annum)	Examines the advice that informed the Government decision to award a \$228 million grant from the NUWDP for an expanded Adelaide Desalination Plant, and assesses the extent to which this grant was consistent with the program guidelines.
4. Grant Management Arrangements	Examines the agreements signed for the two grants, including the development of an arrangement to implement the funding condition in respect to the second grant for a reduction in Adelaide's reliance on the River Murray.

Source: ANAO.

2. Grant Awarded for 50 Gigalitre (per annum) Desalination Plant

This chapter examines the departmental assessment of the application submitted by the South Australian government for a \$100 million grant under the NUWDP to construct a 50GL per annum Adelaide Desalination Plant, and the resulting advice provided to the then Minister that the grant be awarded.

Background

2.1 On 22 December 2008, DEWHA received a funding application from SA Water under the NUWDP for a \$100 million grant towards the construction of the ADP with a capacity of producing 50GL of desalinated water per annum. The stated aim of the project was to diversify Adelaide's water sources, and provide a climate independent source of water. The application stated that SA Water had also submitted an application to Infrastructure Australia for the incremental cost of increasing the plant's capacity from 50GL to 100GL per annum.

2.2 On 27 February 2009, DEWHA briefed the then Minister for Climate Change and Water on its assessment of the SA Water grant proposal. Consistent with the department's recommendation, on 23 March 2009, the then Minister approved a \$100 million grant under the NUWDP to the 50GL per annum ADP subject to two conditions:

- the project comply with the National Water Initiative Pricing Principles and their implementation arrangements, which were at that time being finalised; and
- SA Water provide evidence of an energy procurement strategy that meets the NUWDP funding criteria.⁴⁷

2.3 In line with the audit objective, ANAO examined the departmental assessment of the \$100 million application submitted by SA Water, including all the program criteria (outlined in Table 1.1), but with a particular focus on the merit criteria relating to:

⁴⁷ Also, on 23 March 2009, the Minister wrote to the Premier of South Australia offering the \$100 million in grant funding (subject to the two funding conditions) and advising that the South Australian Government's request for additional funding to expand the capacity of the plant was being considered separately.

- the level of contribution the project could be expected to make to enhancing Adelaide's water supply security;
- project cost-effectiveness; and
- the cost-effectiveness of an Australian Government funding contribution.

Information on the project assessed by the department

2.4 The funding request submitted by the relevant South Australian government entity (SA Water) was provided on a NUWDP application form, with a range of supporting material attached. In summary, the application sought \$100 million⁴⁸ towards the construction of a 50GL per annum ADP, including a transfer pipeline system to supply treated water to the Happy Valley supply zone in southern metropolitan Adelaide. The total estimated eligible capital costs for the project were stated to be \$1.37 billion, including \$168.2 million in contingencies (12.3 per cent of the budget) and \$80 million in acceleration costs.⁴⁹ The major component of the estimate (at \$745 million) related to the costs of designing and constructing the plant, the marine intake and outfall system and pre-commissioning, commissioning and performance testing. DEWHA did not seek any further information from SA Water to clarify or expand upon the information included in the application.

2.5 At the time the SA Water application was submitted, there was also a range of publicly available information about the project. This included the reports (and associated project submissions by SA Water and hansard testimony) of the South Australian Public Works Committee. That Committee had separately inquired into a temporary pilot desalination plant (the report was published in March 2008) and the 50GL per annum plant (the report was published in November 2008). In addition to examining the need for the project from the state's perspective, the expected costs and proposed project delivery method, the Committee was apprised that:

- the ADP was designed to be capable of being operated at staged capacities and could also be shut down if not required; and

⁴⁸ The NUWDP guidelines published earlier in December 2008 had stated that grants under the program were capped at 10 per cent of eligible capital costs up to a maximum of \$100 million per project.

⁴⁹ In his report on SA Water for 2007–08, the South Australian Auditor-General noted that, in July 2008 State Cabinet had approved the acceleration of the procurement of the full scale ADP, and that this was to be achieved through shortening the tendering, construction and commissioning processes.

- in situations where sufficient 'cheaper' water was available from storages in the Mount Lofty Ranges and the River Murray, the plant would be shut down.

2.6 In addition to the Public Works Committee material, the South Australian Auditor-General had commented on the ADP project in his annual report for 2008 to the South Australian Parliament on the audit of financial statements of SA Water and other state entities.⁵⁰

2.7 In this context, in November 2012 ANAO sought advice from DSEWPac as to whether the department examined any publicly available material to inform its merit assessment. In December 2012, DSEWPac advised ANAO that:

The publically available South Australian Government policy document '*Water for Good*' was used to inform DSEWPac's negotiating position on the environmental benefits condition relating to the Australian Government funding of \$228 million for expansion of the ADP to 100 GL/yr.

File 2008/04593 contains the publically available reports '*SA Water Annual Efficiency Report November 2008*' and '*Transparency Statement – Part A Water and Wastewater Prices in Metropolitan and Regional South Australia 2009–10*'. The file records do not detail to what extent these documents informed DSEWPac's advice to the government on funding for the ADP.

Results of the departmental assessment of the proposed grant

2.8 The NUWDP application form required that each of the eligibility and merit criteria be addressed by the proponent. SA Water's application indicated that it considered each of the NUWDP eligibility criteria had been met. The application also outlined SA Water's claims against each of the merit criteria.

2.9 Similarly, DEWHA advised the then Minister that the department had assessed the proposal as meeting the program guidelines.⁵¹ In support of this assessment, the briefing included an attachment that:

⁵⁰ Included with the SA Water application was a copy of SA Water's annual report for 2007–08, but this did not include the state Auditor-General's report to the South Australian Parliament.

⁵¹ The then Minister was advised that: 'The key issues raised in our assessment of the SA Water proposal for the 50GL/yr ADP were: the cost effectiveness of the project; the cost effectiveness of an Australian Government contribution; ensuring carbon neutrality for the operation of the plant; and the minimal environmental benefits from the project.'

- listed each of the eligibility and merit criteria included in the December 2008 program guidelines (see Table 1.1);
- recorded that each criterion had been met; and
- provided a 'comment/summary' in respect to each criterion.

Eligibility criteria assessment

2.10 For the assessment of applications to the NUWDP major projects competitive funding round that had opened in December 2008, DEWHA developed and documented an assessment methodology to give effect to the program guidelines.⁵² Assessment of applications to that round was undertaken by a four-member panel comprising two departmental representatives and financial and technical experts from two consultancy firms.

2.11 In respect to assessing eligibility, the major projects round assessment plan included guidance against each of the 11 criteria to assist the panel in identifying applications that did not meet the eligibility criteria. The eligibility (and merit) assessment of the ADP project was undertaken by DEWHA without input from financial and technical experts. Nevertheless, similar considerations were taken into account by DEWHA in its assessment of the eligibility of the ADP project. DEWHA concluded that a \$100 million grant awarded to SA Water⁵³ towards the construction of a 50GL per annum ADP project met each of the program eligibility criteria.

Merit criteria assessment

2.12 The NUWDP major projects competitive funding round assessment methodology involved each application being scored (to a maximum of five) against the individual merit criteria, and an overall weighted score (also to a maximum of five) then being used to rank competing applications. Table 2.1 shows the scoring guide used for each merit criteria.

⁵² In March 2013, DSEWPaC advised ANAO that 'if the ADP were to have been considered under one of the NUWDP's competitively assessed funding rounds, the more appropriate round would have been the major projects round'.

⁵³ As outlined at paragraphs 4.11 to 4.13, neither ADP was implemented through a funding agreement with SA Water.

Table 2.1**Merit criteria scoring guide: NUWDP major projects round**

Score	Criterion 1	Criterion 2	Criterion 3	Criterion 4	Criterion 5
5	Provides a non-climate dependant source of supply that meets 50% or more of a city's average annual use.	Less than \$1 per KL of water capacity	Additional benefits from the Commonwealth's contribution are highly cost effective.	Exceptional. Fully demonstrated compliance with this criterion, no errors, risks, weaknesses or omissions.	
4	Provides a non-climate dependant source of supply that meets 25% to 49% of a city's average annual use.	Between \$1 and \$2 per KL of water capacity	Achieves several cost effective additional benefits from the Commonwealth's contribution.	Superior. Sound achievement of the requirements specified. Some minor errors, risks, weaknesses or omissions which may be acceptable as offered.	
3	Provides a non-climate dependant source of supply that meets 15% to 24% of a city's average annual use.	Between \$2 and \$3 per KL of water capacity	Achieves some additional benefits from the Commonwealth's contribution.	Good. Reasonable achievement of the requirements specified. Some errors, risks, weaknesses or omissions which can be overcome or corrected with minimal effort.	
2	Provides a non-climate dependant source of supply that meets 5% to 14% of a city's average annual use.	Between \$3 and \$4 per KL of water capacity	Achieves some additional benefits but not commensurate with the cost.	Adequate. Minimal achievement of the requirements specified. Some errors, risks, weaknesses or omissions which are potentially possible to correct / overcome.	
1	Provides a non-climate dependant source of supply that meets less than 5% of a city's average annual use.	Between \$4 and \$5 per KL of water capacity	Claims additional benefits from the Commonwealth's contribution but likelihood benefit would be achieved anyway.	Poor to deficient. No achievement of the requirements specified. Existence of numerous errors, risks, weaknesses or omissions which are difficult to correct or overcome.	
0	No material contribution to the water supply security.	Above \$5 per KL of water capacity	Doesn't identify any additional benefits from the Commonwealth's contribution	Unacceptable. Totally deficient.	

Source: The National Urban Water and Desalination Plan: Major Projects Grant Assessment Plan.

2.13 The approach developed for the major projects round recognised that grant proposals will exhibit a degree of merit as opposed to eligibility criteria which are assessed either as being met or not met. However, DEWHA's assessment of the \$100 million ADP grant application did not identify the

extent to which the merit criteria had been met. Rather, the assessment simply concluded that each of the merit criteria had been met.

2.14 Using the major projects round assessment methodology, ANAO analysis was that the assessment of the first merit criterion (weighted at 35 per cent in the major projects round) 'level of contribution to enhancing water supply security within the targeted urban area' did not give sufficient attention to the planned level of operation for the ADP. In addition, the \$100 million ADP application exhibited a low level of merit in terms of the:

- second merit criterion ('cost-effectiveness of the project', weighted at 15 per cent); and
- third criterion ('cost-effectiveness of the Australian Government contribution', weighted at 10 per cent).

Assessment of contribution to water supply security

2.15 The explanatory notes published with the December 2008 NUWDP program guidelines had outlined the type of information required in respect to the criterion 'level of contribution to enhancing water supply security within the targeted urban area' as follows:

Provide information describing the project's contribution to enhancing water supply security within the targeted urban area. This information should include both contextual information and numerical information explaining the contribution of the project to water supply (in average years) and water security (in drought years). Numerical information should include, but is not limited to, the amount of additional water contributed to the supply as a direct result of the project, expressed as:

- volume (expressed as ML) and percentage of current annual consumption (average of past 10 years);
- a percentage of the estimated future average demand over the planning horizon (e.g. 25 years); and
- a percentage of the supply that the project would provide in drought years.

2.16 The requested information was provided by SA Water in its application, as is shown by Figure 2.1.

Figure 2.1**SA Water Application Response to Criterion 1 (Extract)****Table 8 - ADP as a proportion of water supply to metropolitan Adelaide**

Metropolitan Adelaide Water Supply	ML's
Average metropolitan Adelaide consumption for the last 10 years	189,560 ML
Estimated metropolitan Adelaide consumption in 2025*	217,000 ML
Metropolitan Adelaide consumption in a drought year (2007/08)	156,075 ML
Maximum output from 50 GL/a Desalination Plant	50,000 ML
ADP Supply as a percentage of 10 year average	26%
ADP Supply as a percentage of 2025 estimate	23%
ADP Supply as a percentage of drought year	32%

*Estimated demand in 2025 is calculated from table 2 as estimated BAU demand in 2025 of 258 GL, plus additional demand due to climate change 6 GL, less WPA savings of 47GL

Source : SA Water

The above table shows that as a proportion of the average metropolitan Adelaide consumption, that a 50 GL/a Desalination Plant would contribute 26% of the required water. This decreases to 23% of estimated requirements in 2025. But in a drought year such as 2007/08 it increases to 32%.

Source: DSEWPaC records.

Plant operating arrangements**2.17 On 4 October 2012, SA Water announced that:**

To keep costs down for our customers, SA Water is planning to use our lower cost water sources first, which will mean placing the desalination plant in 'standby mode' when these cheaper sources are available.

Improved inflows into the River Murray and Mount Lofty catchments have put us in a position where we can utilise these sources first and we are anticipating the desalination plant may not need to be operated in the upcoming regulatory period after the completion of its 24-month warranty.

This will be subject to ongoing reviews and is a decision we will make only if natural inflows into the River Murray and our catchments are at levels that can support demand.

The Adelaide Desalination Plant is South Australia's insurance policy against future droughts and provides a flexible, climate independent water source, so

we will continue to maintain it to a level where it can be switched on when we need it.⁵⁴

2.18 In the context of this announcement, DSEWPaC has advised the Senate Environment and Communications Legislation Committee that the operation of the ADP is a matter for the South Australian Government, so long as it meets its obligations (in respect to the second grant) to provide the agreed level of environmental water.⁵⁵ However, the extent to which the ADP could be expected to operate was relevant to DSEWPaC's assessment of the funding application submitted by SA Water in terms of two merit criteria, namely the:

- level of contribution to enhancing water supply; and
- cost-effectiveness of the project (see further at paragraphs 2.30 to 2.33).

2.19 In terms of the level of contribution to enhancing water supply criterion, relying on the information provided by SA Water (see Figure 2.1), DEWHA's assessment advice to the then Minister was that the 50GL per annum ADP was able to provide more than one quarter of Adelaide's water needs in a 'normal' year, and up to 32 per cent during a drought year. However, in March 2013, DSEWPaC advised ANAO that:

The guidelines do not include the concept of a 'normal year', only an average concept and drought years. Note that the concept of a normal year in the [ANAO report] (which is not defined⁵⁶) is presumably not the same as the average data sought under the guidelines. In our view, the information sought under the guidelines effectively emphasises the insurance nature of desalination assets and that the conclusion at paragraph 2.14 that the assessment 'did not give sufficient attention to the planned level of operation for the ADP', appears unwarranted. The department did not assume that the plant would run in all years.

2.20 DEWHA's assessment advice reflected the information provided by SA Water concerning the ability of the ADP to meet Adelaide's water needs in both average and drought years. However, notwithstanding the department's advice that it did not assume the plant would run in all years, the assessment did not identify that the figures provided by SA Water were calculated on the

⁵⁴ SA Water Media Release, *SA Water Outlines Priorities for Next 3 Years*, 4 October 2012.

⁵⁵ Senate Environment and Communications Legislation Committee, *Estimates Hansard*, 16 October 2012, p. 45.

⁵⁶ The reference to the contribution the ADP would make to Adelaide's water supply in 'normal' years was, as indicated at paragraph 2.19, made by DEWHA in its assessment briefing and the supporting material provided to the then Minister for Climate Change and Water.

basis that the ADP would operate at its maximum capacity of 50GL per annum in both drought years and average years. In this respect, the program guidelines drew an important distinction in terms of this merit criterion between the contribution a project would make to water 'supply' in average years and water 'security' in drought years.

Water security in drought years

2.21 The Desalination Working Group⁵⁷ noted that Adelaide was faced with developing strategies to deal with four challenges, namely: average increases in water demand due to population growth and changed climatic conditions; managing variability of inflows; reduced inflows due to environmental impacts and environmental flow releases; and balancing security across the distribution system. The Group recommended that a 50GL per annum desalination plant be constructed by 2012 so as to manage reduced inflows up to 2025. It observed that:

Desalination is the only climate independent solution and therefore diversifies Adelaide's water supply. Desalination caps Adelaide's average extraction from the River Murray at the current level (about 40 per cent of average annual supply). Future upgrading of desalination capacity is related to the future management of the Murray-Darling Basin.

2.22 The Working Group's report also noted that, by 2012, a 50GL per annum ADP and interconnection pipelines would provide increased protection against inflow variability, but would not prevent water restrictions and the need for special water sharing agreements in extreme drought.

2.23 In this context, DEWHA's assessment advice to the then Minister that a 50GL per annum ADP would be able to provide up to 32 per cent of Adelaide's water needs during a drought year was consistent with the intended operation of the plant, as outlined in SA Water's application and the attached Desalination Working Group report.

Water supply in 'normal' years

2.24 Both the completed application form submitted by SA Water and the report from the state's Desalination Working Group that was attached to the application had outlined that it was not intended that the ADP be operated at

⁵⁷ The Desalination Working Group was established in March 2007 by the state government to investigate the feasibility of a desalination plant for Adelaide. In November 2007, the Working Group recommended that a desalination plant be built to increase the security of metropolitan Adelaide's water supply system.

capacity to provide a base load supply of 50GL per annum of water to Adelaide. For example, the report of the Desalination Working Group stated that:

Adelaide's water supply is relatively secure except in infrequent severe droughts and the continued use of water from the River Murray is an ongoing option. Thus operationally a desalination plant need not be base load supply.⁵⁸ However, desalination plants and associated infrastructure have high fixed costs around 50 per cent capital and significant, fixed, unavoidable operating costs so that up to 70 per cent of the costs are incurred whether, or not, the plant is used. In these circumstances it is possible to use a desalination plant for peaking supply as "water security insurance" but the cost per kilolitre for water to consumers is significantly increased.

2.25 Similarly, information provided by SA Water to the South Australian Public Works Committee inquiry into the project⁵⁹ advised that:

The flexible operational model adopted for the ADP will allow a high degree of control over how much water the plant produces, which provides flexibility to shut down the plant or reduce production when "cheaper water supplies" are available or storages are sufficiently full. However this flexibility comes at a cost. Further, SA Water is obliged to pay an ongoing 'fixed' cost associated with the investment and to have the desalination plant operator standing by to produce desalinated water in accordance with SA Water's demand. This includes compensation for fixed labour and other costs and, under certain conditions, the costs associated with shutting down, maintaining on standby, and restarting the desalination plant. In the context of economic analysis, these costs are considered a transfer item, however it does highlight the implicit 'insurance' value attached to having desalinated water available at effectively short notice to respond to Adelaide's water demand.⁶⁰

2.26 In addition, under the operations and maintenance contract awarded by SA Water in February 2009⁶¹, the volume of water to be produced by the operator is to be specified by SA Water.

⁵⁸ The Working Group contrasted the planned approach to operating the ADP with the operation of the Perth desalination plant, as follows: 'The Perth plant is also base load water supply because the decline in Perth's supply from existing sources means that it is desirable to run the desalination plant year round.'

⁵⁹ This information was publicly available at the time DEWHA received the application from SA Water.

⁶⁰ SA Water, *Adelaide Desalination Project: Desalination Plant, Transfer Pipeline System and Associated Works – Report to the Public Works Committee*, November 2008, p. 63.

⁶¹ The operations and maintenance contract provides for the plant to be operated and maintained for a period of 20 years from handover of the 50GL per annum plant.

2.27 Based on the major projects round assessment methodology, the ADP operating at full capacity to provide base load water over 10 years would have scored 4 out of 5 in terms of the first merit criterion. Operating at 50 per cent of capacity over 10 years, the ADP would provide 13 per cent of water supply over a 10-year period and 16 per cent of water supply in a drought year, equating to a score of 2 out of 5 under the major projects round assessment methodology. In situations where the ADP was not expected to operate over a 10-year period, a score of zero would have been allocated as the ADP would not be making any actual contribution to Adelaide's water supply (other than as a form of 'insurance').

2.28 These circumstances highlight that there would have been benefits in DEWHA obtaining, as part of its assessment of the SA Water application, a better understanding of the likely operational levels of the ADP, potentially drawing on the work of the Desalination Working Group. The department's advice to the then Minister would have also been more comprehensive. Specifically, although a 50GL ADP operating at full capacity in 'normal' years would have been able to provide more than one quarter of Adelaide's water needs (which was the advice provided by DEWHA), it would have been prudent for DEWHA to have advised the then Minister that:

- it was not intended that the ADP be operated at capacity in average years such that the ADP would not provide one quarter of Adelaide's water needs in those years (which is what DEWHA had advised the then Minister – see paragraph 2.19); and
- when not required, the plant was designed to be operated at lower capacity (including, potentially, not producing any water). In this respect, in March 2013, DSEWPaC advised ANAO that it was 'obvious' that the plant may not operate at full capacity and this 'was documented in the background material available to the Minister'.

Assessment of project cost-effectiveness

2.29 The explanatory notes published with the December 2008 NUWDP program guidelines had advised in respect to the project cost-effectiveness merit criterion that:

Projects must be an effective use of resources. Proposals must demonstrate that they represent an efficient investment in respect to their impact on water supply and water supply security matters.

Proposals should include cost-benefit analysis. This cost-benefit analysis differs from the financial analysis (criterion 9⁶²) in that it considers the costs and impacts to the whole of society rather than just the financial status of the project participants. Any assumptions made in preparing the cost-benefit analysis should be clearly documented. Projects are expected to show that they are financially capable of long-term operation without the need for ongoing subsidies. All proposals should provide detail of the extent to which revenue can be generated through cost recovery.

A key measure of cost-effectiveness is the levelised cost of water supplied as a result of the project, expressed in dollars per Megalitre or Kilolitre. Levelised costs must be included.

Levelised cost of water

2.30 Consistent with the NUWDP guidelines, the assessment methodology for the major projects funding round involved scoring applications against the second merit criterion using the levelised cost of water supplied as a result of the project. The application submitted by SA Water indicated a levelised cost of water per kilolitre of \$3.61. Under the major projects round, this would have seen the application given a score of 2 for this particular criterion (as noted, a score of 5 was the highest that could be achieved against any of the merit criteria).

2.31 A score of 2 against the project cost-effectiveness criterion would have indicated that the ADP application demonstrated a relatively low level of merit in this criterion. However, other information included in the application indicated that the levelised cost of water was understated, such that the application had less merit against the project cost-effectiveness criterion. Specifically, in respect to the levelised cost of water, the application outlined that:

The costs are presented based on the plant operating at capacity as soon as it is installed (August 2011) which provides the most efficient operating strategy for the plant and as such the cheapest unit costs.

2.32 However, as noted at paragraph 2.24, both the application and the report from the state's Desalination Working Group that was attached to the application had outlined that it was not intended that the ADP be operated at capacity. Similarly, as noted at paragraph 2.25, information provided by SA

⁶² Project eligibility criterion 5 in Table 1.1.

Water to the South Australian Public Works Committee inquiry into the project outlined that the plant could operate at a variety of flow levels, and the extent to which the ADP would produce water would depend on the amount of water in storages, and that available by pumping from the River Murray.

2.33 However, in its assessment of the \$100 million grant proposal, DEWHA did not seek to quantify the effect on the levelised cost of water supply of the ADP being operated at other than full capacity.⁶³ Further, the assessment provided to the then Minister made no reference to the levelised cost of water, notwithstanding that the published guidelines had indicated that this was a key measure of project cost-effectiveness (see paragraph 2.29).

Benefit cost ratio

2.34 The May 2008 Budget Papers included a statement focussing on the scope for improved policy and institutional frameworks for infrastructure investment, and investment in skills and training, as these were seen as areas where there was significant scope to lift Australia's productive capacity. In this statement, the Budget Papers⁶⁴:

- recognised that, where governments invest in infrastructure assets, it is essential that they seek to achieve maximum economic and social benefits, determined through rigorous cost-benefit analysis including evaluation and review;
- stated that only public infrastructure projects that meet at least a minimum benchmark social rate of return—determined through rigorous cost-benefit analysis, including evaluation and review—should be funded, and relative social rates of return above the minimum benchmark should be used to prioritise the funding of projects; and
- committed to efficient public infrastructure investment through the development of coordinated, objective and transparent processes for decision-making based on thorough and rigorous cost-benefit analysis.

⁶³ In circumstances where the levelised cost of water was above \$5 per kilolitre, the major project assessment plan required that a score of zero out of five be allocated for the project cost-effectiveness criterion.

⁶⁴ Budget Paper No. 1 2008–09, *Budget Strategy and Outlook*, circulated by The Honourable Wayne Swan MP, Treasurer of the Commonwealth of Australia and The Honourable Lindsay Tanner MP, Minister for Finance and Deregulation of the Commonwealth of Australia for the information of Honourable Members on the occasion of the Budget 2008–09, 13 May 2008, pp. 4–6, 4–13 and 4–15.

2.35 As noted at paragraph 2.29, the published guidelines had required that proposals include cost-benefit analysis, and that any assumptions made in preparing the cost-benefit analysis be clearly documented.

2.36 The application submitted by SA Water outlined that a BCR had not been calculated when the Desalination Working Group recommended that a 50GL per annum plant be constructed, but that a monetary assessment had subsequently been undertaken under two different approaches:

- a cost minimisation approach that considered the relative costs of acquiring additional water licences in lieu of a desalination plant so as to provide an additional 50GL per annum of water to meet expected demand; and
- a cost benefit approach including the calculation of BCRs.

2.37 The assessment advice provided by DEWHA to the then Minister included the results of the cost minimisation analysis, and concluded that ‘the results indicate that it is more cost effective to construct the 50GL per annum desalination plant than purchase high security water entitlements at a price of \$4000 per megalitre or greater’.⁶⁵ However, notwithstanding the May 2008 Budget Papers concerning economic appraisal broadly, and the guidance published with the NUWDP program guidelines concerning the use of BCRs, the assessment advice provided to the then Minister did not reference the BCR analysis submitted with the SA Water application. There was also no evidence that DEWHA scrutinised SA Water’s BCR analysis.⁶⁶

Assumptions used

2.38 The SA Water application outlined that, using risk assumptions reported by the Desalination Working Group of the chance of level 5 water restrictions occurring once in every 45 years without the ADP and once in every 230 years with the ADP, a BCR of between 0.66 and 0.69 had been calculated.⁶⁷ A BCR of less than 1 indicates that a project does not offer net economic benefits.

⁶⁵ In terms of project cost-effectiveness, the covering brief provided to the then Minister also included a comparison of the cost of constructing a 50GL per annum ADP and purchasing high security water entitlements.

⁶⁶ In November 2012, ANAO sought advice from DSEWPac as to whether the department had obtained any expert advice to inform an assessment of the cost-effectiveness of the ADP project (such as a BCR). In December 2012, DSEWPac advised ANAO that ‘The files do not contain a record of any expert advice obtained by DSEWPac to inform an assessment of the cost-effectiveness of the ADP project.’

⁶⁷ At a seven per cent discount rate.

2.39 After presenting the results of the BCR analysis undertaken on the basis of the Desalination Working Group's report, the application then stated that:

The analysis is to the probability of level 5 restrictions occurring. If it is assumed that the incidence of occurrence is greater than 1 in 45 years (that is 1 in 22.5 years), the benefits increase substantially.

2.40 By doubling the chance of level 5 water restrictions occurring compared to that included in the Desalination Working Group report, a BCR of between 1.47 and 1.54 (at a seven per cent discount rate) was able to be achieved. Such a BCR would indicate that the project had economic merit. However, the application did not provide a rationale that supported a calculation that doubled the chance of level 5 water restrictions occurring either in isolation, or in comparison to other possible scenarios.

Methodology used to calculate the project's economic benefits

2.41 The economic analysis was undertaken on the basis that the primary benefit of the ADP would be greater water security. In this respect, the approach taken was that the ADP represented the 'insurance premium' for greater water security. Specifically:

The cost benefit analysis required an assessment of the value of increased water security as indicated by the reduced costs associated with water restrictions and loss of Gross State Product (GSP). The benefits of the ADP relate to lowering the risk of more common water restrictions or the likelihood of a major supply shortfall should a sustained drought occur.⁶⁸

2.42 DEWHA did not critically examine the BCR analysis to be satisfied that the methodology was sound. By way of comparison, similar BCR analysis was provided by South Australia in respect to the 100GL per annum expansion project submitted to Infrastructure Australia, with that entity scrutinising the robustness of the methodology used by the state.⁶⁹ Infrastructure Australia concluded that the BCR analysis could not be relied upon as:

The benefits of this project are measured in terms of Gross State Product⁷⁰ from input output tables. These are not benefits but impacts and cannot be used to

⁶⁸ SA Water, *Adelaide Desalination Project: Desalination Plant, Transfer Pipeline System and Associated Works – Report to the Public Works Committee*, November 2008, p. 64.

⁶⁹ In response to questions from Infrastructure Australia, the South Australian Government outlined that its proposal involved a package of works comprising an expanded ADP, increasing water storage capacity and interconnection pipeline works. In seeking to further assess this proposal in the context of developing the Final Priority List, Infrastructure Australia asked for advice concerning the interdependency of the three projects, including whether it was feasible for the expected benefits to be allocated to produce separate BCRs for the three project components.

⁷⁰ This is the same approach that was taken in the analysis provided to DEWHA.

demonstrate the economic viability of a project from an efficiency point of view. We acknowledge that it is difficult to measure the welfare effects of improved water availability and security however there are numerous studies which have estimated the willingness-to-pay [*values*] for water availability and these could have been used to estimate the benefits of this project.

Assessment of the cost-effectiveness of an Australian Government contribution

2.43 In respect to the principle of achieving value with public money, the CCGs note that:

A fundamental appraisal criterion is that a grant should add value by achieving something worthwhile that would not occur without grant assistance.

2.44 Similar guidance had been provided to agencies in the 2002 version of ANAO's grants administration Better Practice Guide, which was the version available to DEWHA at the time the ADP \$100 million grant proposal was being considered. In this context, ANAO's performance audits of various grant programs have identified that an assessment of the additional value to be achieved from awarding an Australian Government grant is commonly undertaken having regard to one or both of:

- the level of funding being contributed by other parties. Specifically, a high ratio of partnership contributions to Australian Government funding can indicate that the project would proceed without funding assistance from the Commonwealth; and
- whether project activities have already commenced. To address this, it has been common for program guidelines to state that Australian Government funding is not available retrospectively.

2.45 Against this background, the NUWDP program guidelines:

- stated that projects that had already commenced remained eligible to apply for financial assistance but that the proponents of such projects would 'need to demonstrate that the project would deliver additional benefits as a result of funding under the plan'; and
- included a merit criterion relating to the cost-effectiveness of the Australian Government's contribution. The guidelines explained this criterion as follows:

Proposals should clearly identify the additional benefit obtained from the Australian Government contributions. This information should include additional outcomes that result from funding this plan, and may include, environmental and/or social benefits (e.g. use of renewable energy, reduction in the cost of water to end user, etc.).

Project status

2.46 DSEWPaC's assessment of the \$100 million grant proposal towards a 50GL per annum plant was provided on 27 February 2009 to the then Minister for Climate Change and Water. By this date, South Australia had committed to undertaking the construction of the plant, had approved funding for this purpose and entered into contractual arrangements prior to any decision being made concerning Australian Government funding. More specifically:

- the South Australian Government had approved in-principle the construction of a 50GL per annum ADP (in December 2007) and preparations for a pilot plant to investigate the treatment of seawater for detailed design of a desalination plant;
- on 10 November 2008, the South Australian Government approved estimated capital expenditure of \$1.374 billion for a 50GL per annum plant with the capability to expand up to 100GL per annum capacity in the future;
- the development approval process for the 50GL per annum project had been completed (the final development approval was granted by the State Governor on 26 February 2009);
- contracts were executed by SA Water in February 2009 to design, build, operate and maintain a 50GL per annum desalination plant; and
- the South Australian Government had submitted a proposal to Infrastructure Australia for financial assistance to fund an increase in the capacity of the Adelaide Desalination Plant from 50GL per annum to 100GL per annum (together with the construction of a major interconnection pipeline and an increase in storage capacity in the Mount Lofty Ranges).

Departmental assessment

2.47 The assessment advice provided to the then Minister by DSEWPaC was that:

The project would proceed without Australian Government funding. Costs would be recovered from water users.⁷¹ There is no specific additional outcome from the Australian Government investment'.⁷²

2.48 However, DSEWPaC assessed that this merit criterion had been met. This was on the basis that:

The proposal meets the election commitment to be a financial partner in a desalination plant for Adelaide.

2.49 This advice does not sit comfortably with:

- the April 2008 decision by Ministers that NUWDP funding to meet the ADP election commitment was 'subject to a proposal from the SA Government which meets program criteria'; and
- the program guidelines published in December 2008, which had stated that:

Funding already committed under the plan includes ... a desalination plant in Adelaide, South Australia, subject to a proposal which meets the plan's criteria.

2.50 In this respect, in March 2013, DSEWPaC advised ANAO that:

The election commitment was on the basis that 'If South Australia proceeds with a desalination plant for Adelaide then... a Rudd Labor Government will be a financial partner'. This being the case it is unclear how it could be suggested that because South Australia had decided to proceed with a desalination plant, there was no merit in the Commonwealth being a financial partner, when the whole basis of the Government's election commitment was to partner South Australia financially if the project were to proceed.

There is an insurance value of the plant in securing the water supplies to Adelaide. The value of water in drought years is significantly greater than in

⁷¹ In this respect, the application provided to DEWHA by SA Water stated that: 'Should this application be successful, the funding will be used to offset the level of price increases required to be imposed on SA Water's customers to recover the cost of construction and operation of the ADP.' The application included a chart that illustrated the impact of Australian Government funding on the first five years of price increases likely to be imposed – a 0.6 per cent reduction in the annual increase from 17.5 per cent to 16.9 per cent.

⁷² DEWHA's assessment did not examine whether the relatively low contribution being sought from the Australian Government (seven per cent of the estimated project cost) similarly indicated that there were no additional benefits from an Australian Government grant.

average years. This is particularly the case given that the insurance value of the investment includes benefits of avoided economic losses due to impacts of low water availability and high water prices. These aspects should not be discounted.

2.51 Both the broad financial framework and the enhanced grants administration framework (introduced in December 2007) require that proposed grants be assessed as to their consistency with the relevant program guidelines, including where the proposed grant relates to an election commitment. Accordingly, where a proposal is inconsistent with the guidelines for a particular grant program, it is important that Ministers receive sound advice to this effect from their departments. In situations where Ministers may still be disposed to further consider funding such proposals because they are seen as potentially an efficient and effective use of public money, advice should be provided on alternative approaches such as whether the program guidelines should be amended and re-published, establishing a new program or funding source (with the cost potentially offset from the existing program) or working with proponents (where permitted by the extant guidelines) to identify aspects of the proposal (or alternative proposals) that offer value from an Australian Government contribution.

2.52 In this respect, by way of comparison to the approach taken to the ADP \$100 million grant proposal, an alternative approach consistent with the financial and grants administration frameworks was taken to assist the then Minister with her decision-making in respect to the NUWDP major projects round. Specifically, at the conclusion of the assessment process for the major projects round, DEWHA recommended against the award of funding to projects that would proceed, or were proceeding, regardless of whether they were awarded Australian Government funding. The department identified that these projects would not meet the 'cost effectiveness of the Australian Government contribution' merit criterion and were not consistent with the guidance in the CCGs (see paragraph 2.43).

2.53 For the major projects round, DEWHA offered the then Minister a number of options for allocating the remaining program funding. The then Minister decided that the department should negotiate directly with state governments to address the issue of value for money for the Australian Government's contribution to projects, or identify alternative proposals. Following the consideration of additional material provided by the states (and consideration of some additional projects that were put forward), DEWHA recommended the award of up to \$38.65 million in NUWDP funding to three

proposals.⁷³ The then Minister was advised that these projects would ‘provide benefits that would not occur in the absence of Australian Government funding, and are an efficient, effective and ethical use of funds consistent with the policies of the Government.’

Further DSEWPaC advice

2.54 As noted at paragraph 2.48, the assessment record had referenced the status of the project as an election commitment as being a key consideration in reaching the conclusion that the funding proposal satisfied the third merit criterion. Separately, and although not referencing the merit criterion, the covering briefing had advised the then Minister that a NUWDP grant would enable a small reduction in the cost increases for water users. In this context, in April 2013, DSEWPaC advised ANAO that:

DEWHA assessed that the application for the 50 Gegalitre plant met both the eligibility and merit criteria. In its covering advice DEWHA identified that the funding would result in a (small) reduction in cost increases for water users. DEWHA’s assessment was deficient in the attached assessment against criterion 3, for not identifying that a reduction in cost increases for water users is an additional benefit that meets the NUWDP Guidelines. Notwithstanding this deficiency, DEWHA’s overall assessment that the application met the guidelines was correct.

Conclusion

2.55 To enable an assessment to be undertaken against the published NUWDP eligibility and merit criteria, DEWHA obtained from SA Water a funding application together with a range of supporting material. DEWHA assessed the grant proposal as meeting the program guidelines and recommended that the then Minister for Climate Change and Water approve funding of \$100 million under the NUWDP for a 50GL per annum ADP. The Minister agreed to this recommendation.

2.56 The evidence supports DEWHA’s assessment that the application met the NUWDP’s eligibility criteria. However, there were shortcomings in the recorded basis for DEWHA concluding that the merit criterion ‘cost-effectiveness of the Australian Government contribution’ had been met

⁷³ The amount of funding recommended, and approved, for two of the three projects was also reduced as the proponent had sought more funding than was required to undertake aspects of the work that was to provide the identified additional benefits.

and an inconsistency between this basis and the briefing provided to the then Minister. The primary assessment record stated that DEWHA had identified that the project would proceed without Commonwealth funding and there was no specific additional outcome from any Australian Government funding. Nevertheless, the primary assessment record outlined that this merit criterion could be considered met as 'the proposal meets the election commitment to be a financial partner in a desalination plant for Adelaide'.⁷⁴

2.57 Under the grants administration framework all grant spending decisions (including in relation to election commitments that are proposed to be funded from a grant program) should be made in a manner, and on a basis, consistent with the published program guidelines (including the published eligibility and merit criteria). By way of comparison to the approach taken in assessing the first ADP grant, for eligible projects assessed under the competitive major projects round of the NUWDP, DEWHA recommended against the award of funding to those projects that would proceed, or were proceeding, regardless of whether they were awarded Australian Government funding (as such projects were assessed as not meeting the third of the NUWDP's merit criterion, as outlined at paragraph 2).

2.58 Nevertheless, in its covering briefing to the Minister, DEWHA had identified that NUWDP funding would result in a small reduction in cost increases for water users.⁷⁵ In April 2013, DSEWPaC advised ANAO that the reduced cost to water users was the basis on which the third merit criterion had been met. This situation emphasises the importance of assessment records and associated briefings clearly and consistently reflecting the basis for assessment conclusions.

2.59 A factor not effectively addressed by DEWHA in its assessment of the grant proposal related to the amount of water the ADP was expected to contribute to Adelaide's water supply. The flexible operational model adopted for the ADP was intended to allow a high degree of control over how much water the plant produces, which in turn was to provide flexibility to shut down

⁷⁴ In April 2008, Ministers had decided that NUWDP funding to meet the ADP election commitment was 'subject to a proposal from the SA Government which meets program criteria', with a similar caveat on the approval of NUWDP funding included in the published program guidelines.

⁷⁵ Costs were to be recovered over time from users, with the application indicating that a \$100 million grant would reduce by 0.6 per cent (from 17.5 per cent to 16.9 per cent) the annual price increase. The program guidelines had included a reduction in the cost of water to end users as an example of an additional outcome from NUWDP funding that would be considered to demonstrate merit against the 'cost-effectiveness of the Australian Government contribution' merit criterion.

the plant or reduce production when 'cheaper' water supplies are available or storages are sufficiently full. However, this situation was not addressed in DEWHA's assessment of the application against two merit criteria, namely:

- the level of contribution to enhancing water supply. Reflecting the contents of the application submitted by SA Water, DEWHA advised the then Minister that a plant with a 50GL per annum capacity would be able to provide more than one quarter of Adelaide's water needs in a 'normal' year and up to 32 per cent during a drought year. These figures were premised on the plant operating at full capacity each and every year. In this respect, the drought year figure was consistent with the intended use of the plant during periods of reduced inflows (as had been recommended by the state's Desalination Working Group), thereby providing water security/insurance during such periods. However, the 'normal' years figure drawn by DEWHA from SA Water's funding application (see Figure 2.1) overstated the contribution the ADP was expected to make to Adelaide's water supply as it was intended that the ADP would only be used when cheaper water sources were not available which was not expected to be the case in average years; and
- the cost-effectiveness of the project. The assumption that the plant would operate at maximum capacity each year meant that the cost of water to be produced was understated in the funding application.⁷⁶ Further, the assessment advice provided by DEWHA to the then Minister made no reference to the cost of water that would be produced, notwithstanding that the published guidelines had indicated that this was a key measure of project cost-effectiveness, and that data on the cost of water had been included by SA Water in its funding application.

2.60 DEWHA's assessment in terms of the project cost-effectiveness criterion was also limited in scope, as it focused on whether construction of a desalination plant was more cost effective than an alternative approach of purchasing high security water entitlements. This was notwithstanding that the May 2008 Budget Papers had emphasised the importance of Benefit Cost Ratios (BCRs) to informing Government decision-making on public

⁷⁶ Desalination plants involve high fixed costs and significant, fixed, unavoidable operating costs such that the cost per kilolitre of water is greater in scenarios where the plant is not operated at full capacity.

infrastructure projects, and the published NUWDP program guidelines had similarly stated that assessments against the project cost-effectiveness criterion would consider a project's BCR. The SA Water application had included information on BCRs for the project based on various assumptions⁷⁷, but the methodology and assumptions used were not critically examined by DEWHA, and a BCR for the project was not referenced in the assessment advice provided to the then Minister.

Recommendation No.1

2.61 For grant spending proposals that result from election commitments or arise other than through a competitive process, ANAO recommends that the Department of Sustainability, Environment, Water, Population and Communities promote the achievement of value for money by:

- (a) examining the assumptions made in significant grant funding proposals so as to appropriately inform decision-makers about the extent to which a proposal meets the program assessment criteria;
- (b) applying cost benefit analysis as a key input to its advice on decisions about whether to provide Australian Government funding towards public infrastructure projects; and
- (c) providing Ministers with other options should they wish to pursue funding for proposals that are not consistent with the guidelines for the relevant grant program.

DSEWPaC's response:

2.62 *Agreed.*

Finance's response:

2.63 *Agreed in principle. Finance notes that the updated Commonwealth Grant Guidelines (CGGs), which take effect from 1 June 2013, introduce minimum briefing requirements for agency staff where they brief Ministers in their role as an approver of a grant. The briefing requirements provide, among other things, for the written advice to Ministers to include the merits of the proposed grant or grants relative to the grant guidelines and the key consideration of achieving value with public money.*

⁷⁷ BCRs calculated by SA Water drawing on the work of the state's Desalination Working Group, indicated that the project was not cost-effective (with a BCR less than 1.0).

3. Grant to Expand the Plant Capacity to 100 Gigalitres (per annum)

This chapter examines the advice that informed the Government decision to award a \$228 million grant from the NUWDP for an expanded Adelaide Desalination Plant, and assesses the extent to which this grant was consistent with the program guidelines.

Background

3.1 On 14 August 2008, the then Prime Minister announced that, if the South Australian Government decided to expand the capacity of the Adelaide Desalination Plant (ADP) to 80 or 100GL per annum, the Australian Government would be prepared to co-invest with the state up to \$100 million to accommodate the expansion.⁷⁸

3.2 Following this announcement, the South Australian Government made three written requests to the Australian Government for funding to expand the ADP's capacity to 100GL per annum. The requests did not seek \$100 million in funding from the NUWDP, the maximum additional grant announced by the then Prime Minister. Rather, South Australia sought various amounts of funding for the full cost of the ADP's expansion from the Building Australia Fund (BAF).⁷⁹ The requests comprised:

- an October 2008 submission to Infrastructure Australia seeking funding for a collection of water infrastructure projects from the BAF, including \$606 million⁸⁰ in capital costs to expand the capacity of the ADP to 100GL per annum;
- a funding submission the then South Australian Premier provided to the then Prime Minister on 5 February 2009 following a meeting on

⁷⁸ Prime Minister of Australia, *Joint Press Conference with South Australian Premier, Mike Rann and Minister for Climate Change and Water, Penny Wong*, Adelaide, 14 August 2008.

⁷⁹ The BAF was established under the *Nation Building Funds Act 2008*. That Act was part of a package of legislation giving effect to the Government's 2008-09 Budget announcement to establish three new nation building funds that would provide significant investment in transport, communications, energy, water, education, research and health infrastructure to strengthen the economy.

⁸⁰ The request also sought \$87 million in operating expenditure for a 100GL/a plant.

30 January 2009.⁸¹ That submission provided updated figures and sought capital funding of \$305 million⁸² from the BAF towards the ADP's expansion, and a further \$194 million⁸³ to construct an interconnection pipeline from Adelaide's southern to northern supply networks to balance water security across the city; and

- a 31 March 2009 letter from the then South Australian Premier to the then Prime Minister advising that, following further assessment of capital costs for the 100GL per annum ADP expansion, approximately \$150 million in additional costs for electricity infrastructure and associated works would be required. Accordingly, in total, South Australia sought \$456 million for the ADP's expansion.

3.3 On 23 March 2009, shortly prior to the 31 March 2009 letter from South Australia seeking \$456 million in Australian Government funding to expand the ADP the then Minister for Climate Change and Water had approved the \$100 million grant towards the 50GL per annum plant (this decision was not announced at that time). Some five weeks later, on 28 April 2009, the SPBC approved a \$228 million grant from the NUWDP towards the cost of expanding the capacity of the ADP to 100 GL per annum.

3.4 DEWHA became aware of the decision to award \$228 million in NUWDP funding to an expanded ADP on the weekend of 9 and 10 May 2009 (see further at paragraph 3.32). On 11 May 2009, DSEWPac advised the then Minister for Climate Change and Water that 'the Department of Prime Minister and Cabinet, and we understand the Prime Minister's Office, have confirmed that this is a decision that the funding will be made available'.⁸⁴ Consequently, on 12 May 2009 the then Minister for Climate Change and Water issued a media release announcing that:

⁸¹ On 13 May 2009, in response to a question about the impact for South Australia of infrastructure announcements in the federal Budget, the then South Australian Premier informed the South Australian House of Assembly that: 'When I met with the Prime Minister to outline the state's priorities for Infrastructure Australia projects, I identified water, public transport and health as the areas most critical to South Australia. We had a meeting in Canberra that went for some hours, and there were meetings before that in Adelaide, Canberra and, indeed, finally, in Hobart.'

⁸² A further \$77 million in operating expenditure for a 100GL per annum plant was also sought.

⁸³ The proposal also sought \$60 million towards operating expenditure for the interconnector.

⁸⁴ This was confirmed by the then Prime Minister in 18 May 2009 correspondence to the then Minister for Climate Change and Water. Specifically, in response to an 11 May 2009 letter from the then Minister for Climate Change and Water regarding proposed implementation arrangements for the \$228 million in funding, the then Prime Minister stated that 'I agree with your proposed approach to ensure that the Commonwealth Government's funding of \$228 million, approved by the Strategic Priorities and Budget Committee of Cabinet, is provided on the basis that the project delivers improved water security for Adelaide and a reduced reliance on the Murray River, along with environmental benefits.'

The Australian Government will commit a further \$228 million to the Adelaide Desalination Plant if capacity is expanded from 50 gegalitres (GL) to 100 GL per year, reducing South Australia's reliance on the Murray River.

This funding will be in addition to \$100 million that has already been committed for the 50 GL plant – bringing the total Australian Government commitment to up to \$328 million if the plant is expanded to 100 GL.

...The commitment will be funded from the Government's *National Urban Water and Desalination Plan*. This plan is part of *Water for the Future* and supports projects that use desalination, recycling and stormwater harvesting to improve water supply security.

Funding will be provided on the basis that the expanded project delivers improved water security for Adelaide and a reduced reliance on the Murray River, along with environmental benefits.⁸⁵

3.5 In the context of the audit objective, ANAO examined:

- the assessment of the ADP expansion project undertaken by Infrastructure Australia;
- the advice provided by relevant agencies that informed the decision to award \$228 million in NUWDP funding; and
- the extent to which the awarded grant was consistent with the NUWDP guidelines.

Infrastructure Australia assessment

3.6 The requests from South Australia for Australian Government funding for the expanded ADP referenced the state's submission to Infrastructure Australia in the context of developing the first national Infrastructure Priority List⁸⁶ and the provision of funding for the project through the BAF.

3.7 As part of the process of developing the first Infrastructure Priority List, an Interim Priority List of 94 projects was publicly released on 19 December 2008. Included in the 94 projects was a \$2.477 billion project titled 'Adelaide's long term water security (Desalination)'. That project had been put forward by the South Australian Government in response to a September 2008 request from Infrastructure Australia to all states and territories to identify

⁸⁵ Senator the Hon Penny Wong, Minister for Climate Change and Water, *Additional \$228 million to Help Secure Adelaide's Water Supply*, Media Release PW Budget 09, 12 May 2009.

⁸⁶ ANAO Audit Report No.2 2010–11 examined the development of the first Infrastructure Priority List.

their infrastructure priorities. In particular, the South Australian Government had identified three related projects that, collectively, were to improve Adelaide's water security:

- Adelaide Desalination Plant – 100GL at a cost of \$2.477 billion seeking Australian Government funding of \$693 million;
- upgrade to Mount Lofty storage capacity at a cost of \$1.667 billion, to be fully Australian Government funded; and
- construction of the North-South Interconnector pipeline at a cost of \$450 million, to be fully Australian Government funded.

3.8 In relation to the Interim Priority List of 94 projects, Infrastructure Australia's December 2008 report had stated that:

In order to finalise the Infrastructure Priority List, Infrastructure Australia proposes to:

- subject the data underpinning the assessment of strategic fit to further detailed scrutiny;
- request the development of comprehensive economic analysis of selected projects, where only a rapid economic analysis is available at this stage;
- ask submitting organisations to provide comprehensive economic analysis of specified projects immediately, if currently available;
- request and scrutinise the detailed demand modelling underpinning the projects; and
- subject the economic modelling methodology to further scrutiny.⁸⁷

3.9 In respect to the proposal from South Australia that included the ADP, Infrastructure Australia asked for advice concerning the interdependency of the three projects, including whether it was feasible for the expected benefits to be allocated to produce separate BCRs for the three project components. Infrastructure Australia's analysis of the material that was provided by the state:

- noted that the proposal had a BCR estimated at between 0.8 and 1.0, raising questions about whether it had economic merit; and

⁸⁷ Infrastructure Australia, *A Report to the Council of Australian Governments*, December 2008, p. 72.

- concluded that the state's BCR analysis could not be relied upon due to a methodological shortcoming (discussed in paragraph 2.42).

3.10 Accordingly, the South Australian proposal that incorporated an expanded ADP was not included in the Final Infrastructure Priority List published on 12 May 2009.⁸⁸

Building Australia Fund evaluation

3.11 In addition to its role in developing Infrastructure Priority Lists, Infrastructure Australia is responsible under the *Nation Building Funds Act 2008* for advising Government on water infrastructure proposals for funding under the BAF. In November 2008, the Minister for Infrastructure, Transport, Regional Development and Local Government (the Infrastructure Minister) asked that Infrastructure Australia provide advice on whether project proposals received as part of the development of the first Infrastructure Priority List met the interim BAF evaluation criteria.

3.12 The second of the interim BAF evaluation criteria was:

Extent to which proposals are well justified with evidence and data.

- a) Proposal should demonstrate through a thorough cost-benefit analysis that the proposal represents good value for money.
- b) Project should indicate an expectation of long term public benefits, taking into account economic, environmental and social aspects of the project.

3.13 Interim BAF evaluation criterion 2(a) was closely aligned with the published methodology for compiling the Infrastructure Priority List, which had outlined that objective cost-benefit analysis (through BCRs) would be used as the 'primary driver' of decision-making. Similarly, the second NUWDP merit criterion was 'cost-effectiveness of the project' with the program guidelines stating that, in terms of this criterion, proposals should include cost-benefit analysis (see further at paragraph 2.29).

3.14 Of the submissions received by Infrastructure Australia relating to the transport, water, energy and communications sectors (those sectors covered by the BAF), Infrastructure Australia found that:

⁸⁸ The Hon Anthony Albanese MP (Minister for Infrastructure, Transport, Regional Development and Local Government), *Investing in the Nation's Infrastructure Priorities*, Media Release, 12 May 2009.

only 40 projects contained cost-benefit analysis with a BCR above 1.5 and therefore have the potential to demonstrate good value for money against BAF evaluation criterion 2(a). Of the 40 projects, 9 projects contain cost benefit analysis which was rated as robust and therefore have demonstrated value for money under criterion 2(a) and have been assessed in full against the interim BAF evaluation criteria.

3.15 Infrastructure Australia had identified a shortcoming in the BCR methodology used for the ADP expansion project (see paragraph 2.42). In any event, the BCR for the project was assessed as too low (see paragraph 3.9). Consequently, on 7 April 2009⁸⁹ the Infrastructure Minister advised the then Prime Minister that the 'Adelaide Urban Water Priorities' proposal seeking \$456 million from the BAF was not eligible for BAF funding. Specifically:

The submission to Infrastructure Australia had a benefit cost ratio of less than one. As such, it was not considered for inclusion in Infrastructure Australia's list of priorities and clear potential projects.

Agency advice on a further grant

3.16 Providing advice to government is a core function of the Australian Public Service. In this context, the July 2008 report of the Strategic Review of the Administration of Australian Government Grant Programs (the Strategic Review)⁹⁰ supported the retention of the requirement that had been in place since December 2007 (through Finance Minister's Instructions) that Ministers not approve a proposed grant without first receiving agency advice on its merits relative to the guidelines for the relevant program. The Strategic Review's report described this process as:

a prudent control, designed to ensure that where Ministers elect to assume a decision-making role in relation to the award of grants, they are well-informed of the department's assessment of the merits of grant applications and suitably briefed on any other relevant considerations.⁹¹

3.17 The Government agreed in December 2008 to the Strategic Review's recommendation that:

⁸⁹ In response to a 20 March 2009 SPBC request that the Infrastructure Minister bring forward details of new policy proposals for consideration of funding from the BAF.

⁹⁰ The review was commissioned by the Australian Government with the stated objective of improving efficiency, effectiveness, accountability and transparency in the administration of grant programs across the Commonwealth.

⁹¹ Mr Peter Grant PSM, *Strategic Review of the Administration of Australian Government Grant Programs*, 31 July 2008, pp. 7 and 62.

where Ministers⁹² assume the role of an approver under FMA Regulation 9, they should be required to receive and consider agency advice on the merits of grant applications, as assessed against the relevant program guidelines, before taking any decisions on the award of individual grants; this requirement should apply to all grant spending proposals, including proposals designed to satisfy commitments made in the context of an election campaign.⁹³

3.18 Accordingly, the requirement for Ministers to obtain agency advice before considering whether to approve a grant was incorporated into Finance Minister's Instructions issued in January 2009, and subsequently reflected in the CGGs as follows:

The Australian Government has agreed that where a Minister exercises the role of a financial approver relating to a grant, they will not approve the grant without first receiving agency advice on the merits of the proposed grant.⁹⁴

3.19 As is reflected in the related provisions of the CGGs, this requirement does not affect a Minister's right to decide on the awarding of grants.⁹⁵ Rather, together with other related enhancements to the grants administration framework, it provides for an improved decision-making framework that assists Ministers to be appropriately informed when deciding whether to approve grants and promotes transparency around the reasons for decisions.⁹⁶ Typically, it is expected that this advice be provided by the agency that administers the particular grant program. In this respect, in March 2013, the Department of Finance and Deregulation advised ANAO that:

- it agreed that agency advice should be provided on the merit of a proposed grant, relative to the relevant grant program guidelines, before a funding decision is taken;

⁹² The decision about whether to spend public money may be made by a Minister, by Ministers collectively (such as in Cabinet), an agency Chief Executive, officials acting under the authority of a Minister or their Chief Executive, or other persons authorised by legislation to make such decisions.

⁹³ Strategic Review, *op. cit.*, Recommendation 2(b), p. 66.

⁹⁴ *Commonwealth Grant Guidelines, Policies and Principles for Grants Administration*, Department of Finance and Deregulation, July 2009, paragraph 3.19, p. 10.

⁹⁵ Specifically, inclusion of the obligation for Ministers to advise the Finance Minister of grants they have approved that the relevant agency had recommended be rejected implicitly acknowledges that Ministers are not required to agree with agency recommendations when considering whether to approve a grant.

⁹⁶ The Joint Committee of Public Accounts and Audit has reiterated the importance of agencies providing advice on the merits of proposed grants before any funding decisions are taken. See: Joint Committee of Public Accounts and Audit, *Report 423: Review of Auditor-General's Reports Nos 39 2009–10 to 15 2010–11*, Canberra, July 2011, p. viii.

- central agencies do not have ‘the same capacity or access to information that is required to evaluate a grant proposal against the relevant program guidelines’; and
- ‘it would be inappropriate and inconsistent with the Administrative Arrangements Orders for central agencies to take on the role of a line-agency in an area for which a line-Minister is responsible’.

3.20 The requirement for agency advice also reinforces the statutory obligations under FMA Regulation 9 relating to the approval of proposals to spend public money. At the time the two ADP grants were approved, FMA Regulation 9 required that a spending proposal not be approved unless the approver was satisfied, after undertaking such inquiries as are reasonable, that the proposed expenditure:

- was in accordance with the policies of the Commonwealth; and
- would make efficient and effective use of the public money.⁹⁷

3.21 The guidelines applying to a particular grant program are a policy of the Commonwealth that must be considered before any decision is made to spend public money on a grant. In this context, where the proposed grant is not consistent with the relevant program guidelines, FMA Regulation 9 requires that the spending proposal not be approved.

Central agencies advice

3.22 In the context of the global financial crisis, a series of SPBC meetings were held in April 2009 to consider funding for infrastructure projects, including funding for the ‘Adelaide Urban Water Priorities’ proposal. Departments, including DSEWPac, did not provide formal submissions for these meetings. However, advice specific to the ADP’s expansion was provided by central agencies on two occasions, with particular input from the Department of Finance and Deregulation (Finance) and the Department of the Prime Minister and Cabinet (PM&C). This advice indicated that the proposal was not supported by a full business case, the quality of the costings was low and the Commonwealth’s exposure to project risk was high. Central agencies did not recommend that NUWDP funding be awarded (as neither central

⁹⁷ The terms of FMA Regulation 9 were to be read conjunctively such that the requirement was for an approver to comply with each paragraph in considering whether to approve a spending proposal. See further in ANAO Audit Report No.4 2001-2002, *Commonwealth Estate Property Sales*, Canberra, 1 August 2001, p. 92.

agency had assessed the merits of the proposal in terms of the program guidelines) but, rather, supported further consideration of \$228 million in funding for the expanded ADP under the NUWDP.

DEWHA assessment and advice

3.23 As noted at paragraph 2.2, DEWHA's assessment of the application from SA Water for \$100 million in grant funding towards a 50GL per annum ADP was finalised on 27 February 2009. At the time of undertaking its assessment of that grant proposal, DEWHA was aware that Infrastructure Australia was assessing a proposal from South Australia that included funding towards an expanded ADP. DEWHA had also received a copy of the then South Australian Premier's 30 January 2009 funding submission, shortly after it had been provided by South Australia to the then Prime Minister.⁹⁸

3.24 DEWHA was not asked by Ministers to assess a proposal for funding an expanded ADP in terms of the NUWDP program guidelines. The department also did not:

- suggest to Ministers that the proposal be assessed against the NUWDP program guidelines;
- propose that South Australia be asked to submit an NUWDP funding application as part of the major projects round that opened for applications in December 2009 (with applications closing on 30 June 2009); or
- otherwise initiate any assessment of the merits of further NUWDP funding being awarded to the ADP.

3.25 In its 27 February 2009 brief to the then Minister for Climate Change and Water, DEWHA noted that:

If Infrastructure Australia does not consider the ADP expansion a priority, there is still opportunity to consider approving up to an additional \$100 million offered by the Prime Minister on 14 August 2008.

⁹⁸ DEWHA had not been provided with the results of the Infrastructure Australia assessment, which had been communicated to the then Prime Minister, the then Deputy Prime Minister, the Treasurer and the then Minister for Finance and Deregulation on 7 April 2009 (see paragraph 3.15).

3.26 However, that briefing, and a later briefing submitted on 7 April 2009⁹⁹, were premised on allowing the Infrastructure Australia processes to be completed, and consideration was not given to whether, and at what stage, any assessment of the ADP expansion proposal should be undertaken in terms of the NUWDP program guidelines, in the event Infrastructure Australia did not include the ADP expansion proposal on the Final Priority List.

3.27 On 2 April 2009, DEWHA was asked by Finance to provide some ‘quick thoughts’ on the 5 February 2009 proposal received from the South Australian Premier, requesting capital funding of \$305 million towards the ADP’s expansion and \$194 million for constructing an interconnector pipeline (see paragraph 3.2). Specifically, Finance sought input as to ‘whether it’s worthwhile, priority against other projects, cost, whether covered by other water programs etc’.

3.28 At that stage, DEWHA was not aware of the then Premier’s 31 March 2009 correspondence that sought \$456 million for the expansion of the ADP. A copy of this correspondence was provided to DEWHA by PM&C on 8 April 2009. DEWHA on-forwarded this correspondence to its then Minister’s office and advised that ‘the letter slightly amends the amount of money sought by SA, but essentially the issues in the [7 April 2009] brief¹⁰⁰ remain current.’

3.29 In addition, on 21 April 2009, DEWHA was asked by PM&C for some information on the NUWDP including the funding profile for the program and the extent to which this funding had not yet been allocated, dates applying to the various NUWDP funding rounds and the program requirements (such as any caps of funding).

3.30 In response to these inquiries from central agencies, DEWHA did not initiate any consideration as to whether funding the expansion to the ADP from the NUWDP would be in accordance with the NUWDP program guidelines (including, but not limited to, the eligibility and merit criteria). In April 2013, DSEWPaC advised ANAO that:

⁹⁹ The purpose of that briefing was to provide requested further information to the then Minister on a negotiating strategy that would achieve a reduced call on the River Murray should additional Australian Government funding be provided to expand the capacity of the ADP.

¹⁰⁰ See footnote 99 in respect to the purpose of that briefing, which did not involve any assessment of the expansion proposal in terms of the NUWDP program guidelines.

DEWHA was not aware that Cabinet was considering the National Urban Water and Desalination Plant (NUWDP) as a possible funding source for the Adelaide Desalination Plant (ADP) expansion proposal. DEWHA understood the expansion of the ADP was being considered for funding from the Building Australia Fund and was not advised of the outcome of that process.

... The request from PM&C [see paragraph 3.29] was not sufficient information for DEWHA to draw the conclusion that the Building Australia Fund process had concluded, and that the NUWDP was under active consideration. DEWHA was not asked to, and did not of its own accord, initiate an assessment of South Australia's application to the Building Australia Fund against the NUWDP guidelines.

DEWHA expected that if the ADP expansion was not funded by the Building Australia Fund, then DEWHA would be involved in a subsequent and separate process to consider additional funding from the NUWDP.

3.31 In this context, there would have been benefits in DEWHA advising its then Minister that, in addition to seeking to secure environmental benefits¹⁰¹, any decision to award further funding of the ADP through the NUWDP would (to comply with the grants administration framework decided upon by Ministers in December 2008) need to be informed by DEWHA advice on the merits of the proposal against the program guidelines, preferably through the competitive major projects round that was at that time open to applications.¹⁰²

DEWHA advice after the funding decision was taken

3.32 It was not until some days later that DEWHA became aware of the government decision of 28 April 2009 to award NUWDP funding towards an expanded ADP.¹⁰³ In a subsequent (11 May 2009) briefing to its then Minister¹⁰⁴,

¹⁰¹ A briefing was provided on 7 April 2009 (see paragraph 3.26) and further advice was provided on 8 April 2009 (see paragraph 3.28) but neither outlined the process that would need to be employed (under the grants administration framework) if it eventuated that the ADP expansion was not supported by Infrastructure Australia and funding was to be provided through the NUWDP. In this respect, the earlier 27 February 2009 briefing, relating to the approval of the \$100 million grant, had recognised that Infrastructure Australia may not consider the ADP expansion a priority, but this briefing similarly stated that the department would recommend any funding for the ADP expansion be conditional on the return of River Murray water entitlements and did not outline that in December 2008 the Government had reaffirmed that decisions to award grants were to be informed by agency advice on the merits of the proposal in terms of the program guidelines.

¹⁰² The enhanced grants administration framework includes a preference for competitive, merit-based selection processes.

¹⁰³ PM&C records of 1 May 2009 state that 'the project will get an additional \$228 million from DEWHA's National Urban Desalination Plan [sic], but DEWHA does not know this yet.' DEWHA became aware of the decision to award \$228 million in NUWDP to an expanded ADP on the weekend of 9 and 10 May 2009.

the department referred the Minister to its earlier assessment that a \$100 million grant towards a 50GL per annum ADP satisfied the NUWDP criteria, and advised that the 'expanded plant would also meet these criteria'.¹⁰⁵ This advice was provided notwithstanding that DEWHA had not examined the expansion project against the NUWDP program guidelines.

3.33 In that briefing, DEWHA further advised that the decision to fund the expanded ADP:

be explained as follows:

- The ADP was assessed outside of the competitive process but against the criteria of the NUWDP. This was indicated in the publicly released program guidelines.
- The additional funding was provided as this was a specific election commitment of the Government and because the ADP will provide wider benefits by reducing the call on the Murray. Project conditions will apply to ensure that this is achieved.

3.34 In commenting on draft correspondence from the then Minister for Climate Change and Water to the then Prime Minister concerning the approval of \$228 million in NUWDP funding for the expanded ADP, Finance noted that the guidelines stated that 'Funding already committed under the plan includes ...a desalination plant in Adelaide, SA, subject to a proposal from the South Australian Government that meets the plan's criteria'. Finance recommended that this qualification be included in the letter to the Prime Minister, together with information about whether this condition had been met or how it would be. Although a draft of this correspondence provided by DEWHA to the office of the then Minister for Climate Change and Water included a statement to this effect, it was not included in the letter signed and sent to the then Prime Minister.

3.35 In this context, notwithstanding the approach proposed by DEWHA in its briefing to the then Minister for Climate Change and Water, there was no evidence in the records held by either DEWHA or the two central agencies that

¹⁰⁴ This briefing recommended that the then Minister write to the then Prime Minister proposing that the funding approved by the SPBC be conditional on an arrangement that ensures improved water security for Adelaide and a reduced call on the Murray River with environmental benefits. As indicated at paragraph 3.4, the then Minister wrote to the then Prime Minister in respect to this proposed funding condition, which the then Prime Minister agreed to on 18 May 2009 (as well as confirming the approval of funding by the SPBC).

¹⁰⁵ Similarly, the Implementation Plan signed in respect to the 100GL expansion project stated that 'This Project is consistent with the objectives and funding criteria for the National Urban Water and Desalination Plan'.

an assessment had been undertaken by DEWHA (or central agencies) of the grant spending proposal towards an expanded ADP in terms of the NUWDP criteria.¹⁰⁶ In addition, the guidelines had stated that NUWDP funding to the ADP was subject to a proposal from the South Australian Government that met the NUWDP criteria. The \$100 million grant had been assessed against the NUWDP criteria, but the expansion proposal had not been assessed, notwithstanding the requirements of the grants administration framework.

Requirements of the NUWDP program guidelines

Process by which NUWDP funding could be accessed

3.36 An early and important consideration in the design of a grant program is establishing how to structure the process by which potential funding recipients will be identified and are able to access the program. In this context, in December 2008, the Government made decisions concerning the July 2008 report of the Strategic Review of Grants Administration, including agreeing to a recommendation that a principles-based whole-of-government policy framework be developed for the administration of grant programs across the Commonwealth. The principles proposed by the Strategic Review were endorsed, including in respect to probity and transparency that ‘unless specifically agreed otherwise, competitive, merit-based selection processes should be used, based upon clearly defined selection criteria and with due attention to probity principles.’ In this respect, the CGGs that took effect on 1 July 2009 stated that, unless specifically agreed otherwise, competitive, merit-based selection processes should be used, based on clearly defined selection criteria.

3.37 In addition, in December 2008 when making decisions about the enhanced grants administration framework after considering the July 2008 report of the Strategic Review, the Government agreed to recommendations that:

- should a Minister wish to have the flexibility to provide grant funding outside of regular program guidelines and processes, this intention should be made transparent in the design of the program and authorised explicitly in Cabinet’s approval of the new policy proposal; and

¹⁰⁶ Information to allow such an assessment to be undertaken was not requested from South Australia.

- Ministers should be required to receive and consider agency advice on the merits of proposed grants, as assessed against the relevant program guidelines, before taking any decisions on the award of individual grants (and that this requirement should apply to all grant spending proposals, including those designed to satisfy commitments made in the context of an election campaign).

3.38 In respect to accessing NUWDP program funding, as noted at paragraphs 1.6 and 1.14, the election policy announcement that the NUWDP would be established had stated that, to achieve value for money, all program funding would be decided through competitive processes with Infrastructure Australia to undertake an independent cost-benefit assessment of all proposals for NUWDP funding. However, the December 2008 program guidelines reflected the decision made after the election that five election commitments would be funded from within the NUWDP. Nevertheless, the remaining program funding was to be subject to competitive process governed by guidelines issued in relation to three competitive funding rounds conducted for stormwater harvesting and reuse projects and, in other respects¹⁰⁷, the December 2008 program guidelines.¹⁰⁸ In this respect, the December 2008 guidelines stated that:

Financial assistance under the plan will be determined through a competitive process ...

3.39 The December 2008 guidelines also set out the process for preparing and submitting a proposal for NUWDP funding. This process was to involve potential applicants discussing their project proposal with DEWHA, and the submission by 30 June 2009 of an on-line application to the department. Submitted proposals were then to be assessed by DEWHA, 'drawing on expert advice as appropriate', before recommendations would be made to the Minister for Climate Change and Water who would make the funding decisions.

3.40 The process by which the proposal for the expansion of the ADP obtained NUWDP funding was inconsistent with the process outlined in the NUWDP program guidelines. As a result, the majority of the available

¹⁰⁷ As noted at paragraph 1.11, in the context of an ANAO audit of the development and approval of grant program guidelines, DSEWPac advised ANAO that the December 2008 guidelines 'cover the program generally'.

¹⁰⁸ The December 2008 guidelines governed a competitive application round for major projects that was being conducted at the same time as South Australia sought funding for an expanded ADP.

program funding (\$441.38 million or 64 per cent) has been allocated to meet projects selected other than through a competitive process.¹⁰⁹

3.41 ANAO has previously drawn attention to the challenges to equitable and transparent grants administration that arise in situations where funding is awarded to projects that have not been considered through the competitive process planned for the program. Such an approach can also lead to budgetary risks. Specifically, where insufficient program funding remains available to conduct a competitive application process due to program funding being awarded to proposals through non-competitive processes, there can be pressure to increase the quantum of program funding.¹¹⁰ That situation did not arise in respect to the NUWDP, as the major projects funding round did not directly result in any applications being awarded funding and, even after negotiations were undertaken with various state governments, a relatively small amount of program funding was awarded (up to \$38.65 million in respect to three proposals (see further at paragraph 2.53).

Program parameters

3.42 As with many grant program guidelines, in addition to specifically labelled eligibility and merit assessment criteria, the NUWDP program guidelines established certain requirements a project proposal needed to satisfy in order to be considered for funding.

3.43 In this context, the NUWDP guidelines limited the amount of financial assistance available under the program to 10 per cent of eligible¹¹¹ capital costs up to a maximum of \$100 million per project. A grant of \$228 million was inconsistent with these caps as it:

- represented 50 per cent of the capital costs of the expansion advised in the then Premier's 31 March 2009 correspondence; and
- was significantly greater than the \$100 million cap on funding applying to each project.

¹⁰⁹ A recent ANAO audit examining the development and approval of grant program guidelines concluded that the use of non-competitive selection process has remained relatively common, notwithstanding the preference expressed in the grants administration framework for competitive, merit-based selection processes. See ANAO Audit Report No. 36 2011–12, *Development and Approval of Grant Program Guidelines*, Canberra, 31 May 2012.

¹¹⁰ For example, see ANAO Audit Report No. 30 2009–10, *Management of the Strategic Regional Program/Off-Network Program*, Canberra, 22 April 2010, pp. 15-17 and 21-22.

¹¹¹ Eligible capital costs include the upfront capital costs incurred prior to operations that are necessary to bring the project to a commercially operable status. They included the costs of construction but not the cost of land (including clearing, demolition and landscaping costs).

3.44 The SPBC decision of 28 April 2009 recognised that the \$228 million grant was greater than the \$100 million NUWDP program funding cap, but did not address the issue of the grant value being greater than 10 per cent of the estimated eligible capital costs.

3.45 After becoming aware of the funding decision, on 11 May 2009¹¹², DEWHA provided advice to the then Minister for Climate Change and Water regarding a proposed approach to the additional funding. In respect to the cap on program funding contributions, DEWHA's advice stated that:

We strongly recommend that the NUWDP guidelines not be amended as a result of this decision. The guidelines are for the competitive element of the plan and proposals are due in June. It has always been clear that ADP, like other election commitment projects, was not being considered through the competitive process and this was made clear in the guidelines ...

The assessment criteria for the NUWDP do not specify a cap of funding – this is specified elsewhere in the guidelines.

3.46 This advice did not recognise that the additional funding of \$228 million did not relate to an election commitment. In this respect, earlier advice from DEWHA to its then Minister had recognised that the \$100 million grant towards a 50GL per annum ADP satisfied the election commitment announcement of an Australian Government 'financial contribution' towards the construction of a desalination plant for Adelaide.

3.47 Further, as noted at paragraphs 3.16 to 3.21, the financial framework requires that proposed grants be assessed relative to the program guidelines in their entirety, not only the assessment criteria as suggested by DEWHA.¹¹³

3.48 The decision to approve a larger grant than permitted by the guidelines also meant that proponents were treated inequitably in the assessment of projects for NUWDP funding. For example, in May 2009 the Victorian Department of Treasury and Finance (DTF) contacted DEWHA to seek confirmation of why the Commonwealth was willing to provide up to \$328 million for the ADP under the National Urban Water and Desalination Plan when the funding under the plan was capped at \$100 million. Further, DTF's application for funding the Victorian Desalination Project under the

¹¹² See further at paragraphs 3.32 and 3.33.

¹¹³ In developing the DEWHA advice to its then Minister, Finance had also supported an approach that focused solely on the program criteria, commenting to DEWHA that: 'We note that the level of funding goes beyond the cap under the program but, as the cap is not part of the eligibility criteria, this outcome does not seem to be precluded for this project'.

NUWDP major projects round noted the funding cap and that the ADP had been provided with \$328 million for a facility around one third of the size of its project.

Level of contribution to water supply security merit criterion

3.49 Self-evidently, constructing a 100GL per annum ADP provided increased water security/insurance than that provided by a 50GL per annum plant. In this context, the first NUWDP merit criterion related to the extent to which project proposals would contribute to enhancing water supply security within the targeted urban area (see further at paragraph 2.15). The program guidelines outlined that information in terms of this criterion should include both contextual and numerical information explaining the contribution of the project to water supply (in average years) and water security (in drought years).

3.50 Contextual information on South Australia's future water needs was included in SA Water's application for \$100 million to assist in the construction of the 50GL per annum ADP that was assessed by DEWHA. The submission included analysis from a report prepared by the Desalination Working Group identifying estimates of future water shortages in South Australia, which highlighted that:

- the 50GL per annum of water produced by the desalination plant would be sufficient to meet South Australia's expected additional water requirements through to the year 2025. In this respect, SA Water's application for funding towards the 50GL per annum plant advised that a plant with this capacity was expected to reduce the risk of level 5 water restrictions from a 1 in 45 year chance without a 50GL per annum ADP to 1 in 230 years with a 50 GL per annum ADP; and
- an additional 50GL per annum (100GL per annum in total) would be required in the period after 2025 and to meet additional demand through to 2040. Specifically, the Working Group report stated that:

By 2025 inflows in the Mt Lofty Ranges are expected to reduce on average by 30GL and River Murray licences will be reduced by 15GL, giving a 45GL reduction in water availability. When combined with 5GL of demand increases that are not met by Water Proofing Adelaide savings, there is a need for 50GL of additional water for Adelaide.

It is recommended that this be provided by a 50GL desalination plant because this option does not increase reliance on the River Murray and achieves a further level of diversification.

3.51 Accordingly, as illustrated by Figure 3.1, the Working Group had recommended that, to manage reduced in-flows, a 50GL per annum ADP be constructed by 2012 with an expansion in the capacity of the ADP required beyond 2025.¹¹⁴ As was reflected in the information provided by SA Water to the South Australian Public Works Committee's June 2009 inquiry into the expansion project, the ADP expansion was expected to provide increased insurance in terms of long-term (between 2025 and 2050) water security but water from an expanded plant was not expected to be needed in the short-term. In this respect, in March 2013 DSEWPaC advised ANAO that:

The plant started providing an increased insurance benefit from the time it became operational because extreme drought can occur in any year, notwithstanding that it is historically rare. In particular, the 100GL plant could be expected to have been utilised, had it been available, during the years of drought that occurred before 2010, within which time the Coorong and Lower Lakes of the Murray system faced environmental catastrophe. While this event is (thankfully) rare, the fact that it has occurred recently does not make it less likely to occur in the near future. The potential impact of climate change is also of relevance in this respect.

¹¹⁴ As noted at footnote 61, the operations and maintenance contract provides for the plant to be operated and maintained for a period of 20 years from handover of the 50GL per annum plant.

Figure 3.1

Desalination Working Group Summary of Recommendations

	Up to 2025	Beyond 2025
Increases in demand	Water Proofing Adelaide demand reduction and re-use initiatives \$250 million Completion date:~ 2025	To be considered in conjunction with reduced in-flows
Managing variability	200 GL increased storage (Mt Bold or equivalent) \$1,110 million Completion date:~ 2017	Strategic reserve in River Murray upstream storages
Reduced in-flows	50 GL desalination plant \$1,097 million Completion Date:~ 2012	50 GL desalination upgrade or purchase of River Murray licences [†]
Balancing security across the distribution system	North-south interconnection pipe work \$304 million Completion date:~ 2014	(Included in first stage works)

([†]Beyond 2025 the purchase of additional River Murray allocations may be an option in lieu of further desalination but this would depend on suitable arrangements to guarantee the reliability of the additional water. This could be through changes to the Murray-Darling Basin Agreement or a greater strategic reserve held in upstream storages.)

Source: DSEWPaC records.

Project cost-effectiveness merit criterion

3.52 As outlined at paragraph 2.29, the explanatory notes published with the NUWDP program guidelines advised that, in addressing the second merit criterion ('cost-effectiveness of the project'):

- proposals must demonstrate that they represent an efficient investment in respect to their impact on water supply and water supply security matters;
- proposals should include cost-benefit analysis; and

- a key measure of cost-effectiveness would be the levelised cost of water supplied as a result of the project.

3.53 No levelised cost of water calculation was provided by South Australia in support of any of the requests made for Australian Government funding towards the expanded ADP. As noted at paragraphs 3.7 to 3.10, Infrastructure Australia examined the cost-effectiveness of the ADP expansion proposal in the context of developing the first Infrastructure Priority List, and concluded that the BCR methodology was not robust and, in any event, the BCR that was calculated was too low.

Cost-effectiveness of Australian Government contribution merit criterion

3.54 As noted at paragraphs 2.43 and 2.44, it has long been recognised as a principle of sound grants administration that a grant should add value by achieving something worthwhile that would not occur without assistance. In this respect, and as noted at paragraph 2.45, the third NUWDP merit criterion required that proposals identify the additional benefit obtained from an Australian Government contribution. In this respect, the program guidelines stated that:

Projects that are already seeking approvals, funding or have commenced are still eligible to apply for financial assistance. The proponents of such projects would need to demonstrate that the project would deliver additional benefits as a result of funding under the plan.

3.55 In respect to whether the 100GL expansion project was proceeding irrespective of whether Australian Government funding:

- the evidence provided by SA Water to the South Australian Public Works Committee shows that the benefit achieved from the Australian Government grant funding was to reduce the cost to be met by the South Australian Government and that reduced costs to the state could then be passed onto water users by a reduction in the price increases that would otherwise have occurred to meet the construction costs; and
- similarly, the South Australian Government's submission to Infrastructure Australia had stated:

Water prices have been set on the basis that committed water security projects would proceed and be funded through increased prices to consumers required to achieve an appropriate return to Government. However if the

Commonwealth was to fund all or a portion of the investment, the impacts to customers would be reduced.

3.56 Further in this respect, the economic analysis of the project provided by SA Water to the South Australian Public Works Committee showed that the effect of the Australian Government's \$228 million was to reduce the costs to the state, rather than allowing the project to proceed.

Environmental benefits

3.57 The focus of DEHWA's briefings to its then Minister in respect to the expanded ADP both before and after the SPBC funding decision was whether a further grant to the project could be used to deliver environmental benefits that would not otherwise be possible. For example, in the period between the Prime Minister's August 2008 announcement and the April 2009 SPBC decision to award a grant, DEHWA briefed the then Minister for Climate Change and Water on three occasions suggesting that South Australia should be required to provide environmental water as part of the conditions of the grant, including:

- a September 2008 suggestion that the South Australian Government be asked for a proposal detailing how much additional water could be recovered for the environment before the Australian Government finalised an additional funding contribution; and a recommendation, not agreed by the then Minister, that funding be conditional on the transfer of a significant volume of urban water entitlement to the Commonwealth Environmental Water Holder (CEWH)¹¹⁵;
- advice in February 2009 suggesting that any funding for the ADP expansion should be conditional on the South Australian Government transferring a significant volume of River Murray water entitlement to the CEWH; and
- advice in April 2009 suggesting that, if additional funding was provided with the objective of reducing the call on the Murray River, the South Australian Government be asked to indicate how it would guarantee the expanded plant would reduce the call on the Murray River and that a condition be included in the funding agreement.

¹¹⁵ The CEWH is a statutory office created under part six of the *Water Act 2007*. The functions of the CEWH include managing Commonwealth environmental water holdings. Such holdings include: water access rights, water delivery rights, irrigation rights or other similar rights relating to water. The CEWH may purchase, dispose of and otherwise deal in water and water holdings. The CEWH's functions are to be performed for the purpose of protecting or restoring the environmental assets of the Murray-Darling Basin and other areas outside the Murray-Darling Basin where the Commonwealth holds water.

3.58 Similarly, in the first briefing provided by DEWHA after the SPBC funding decision, the then Minister was advised that:

The key issue is whether additional Australian Government funding will result in sufficiently reduced extraction from the River Murray.

3.59 However, the South Australian government had not offered to commit to reducing its draw on the Murray River when seeking Australian Government funding for the expansion project. In addition, potential environmental benefits from an expanded ADP were only briefly referenced in central agency advice to the SPBC and were not recorded as being a condition on the award of NUWDP funding. Nevertheless, and as outlined in the next chapter, securing water for environmental flows became a focus for negotiations over the implementation of the \$228 million grant.

3.60 The addition of conditions to the funding occurred after the decision to award the grant had been made and in response to further advice by DEWHA in May 2009 and confirmation through subsequent correspondence between the then Minister for Climate Change and Water and the then Prime Minister. Accordingly, the announcement of the grant on 12 May 2009 included a statement that funding would be provided on the basis that the expanded project would deliver improved water security for Adelaide and a reduced reliance on the Murray River, along with environmental benefits.¹¹⁶ However, the quantum of any environmental benefits, including by reference to the significant quantum of grant funding that had been awarded (\$228 million) was not addressed in the context of the decision to award grant funding to the ADP expansion project.

¹¹⁶ Senator the Hon Penny Wong, Minister for Climate Change and Water; Media Release; *Additional \$228 Million to Help Secure Adelaide's Water Supply*; 12 May 2009.

Conclusion

3.61 The merits of the ADP expansion project were considered by Infrastructure Australia, which examined in detail a submission from South Australia that the project be funded from the Building Australia Fund.¹¹⁷ Infrastructure Australia concluded that the project was not supported by robust cost-benefit analysis and, in any event, the BCR calculated for the project was too low such that it did not offer a net economic benefit. Accordingly, Infrastructure Australia did not include the project on its first Infrastructure Priority List, and the ADP expansion proposal was not eligible for funding from the Building Australia Fund.

3.62 In April 2009, the ADP expansion project was awarded funding from the NUWDP. However, the process by which approval was given for the grant of \$228 million to increase the capacity of the ADP from 50GL per annum to 100GL per annum did not accord with an important aspect of the grants administration framework. Specifically, since December 2007, there has been a requirement that Ministers not approve a proposed grant without first receiving agency advice on its merits relative to the guidelines for the program. However:

- DSEWPaC has advised ANAO that it was unaware of an intention for the project to be funded under the NUWDP and, as a result, the department did not assess the proposal for Australian Government funding towards an expanded ADP against the NUWDP program guidelines before Ministers decided to award the \$228 million grant; and
- advice to Ministers on the proposal was provided by central agencies. The advice indicated that the proposal was not supported by a full business case, the quality of the costings was low and the Commonwealth's exposure to project risk was high. Central agencies supported further consideration of funding the expanded ADP under the NUWDP, but the central agencies did not assess the merits of the proposal in terms of the program guidelines.¹¹⁸

¹¹⁷ ANAO has previously concluded that Infrastructure Australia's methodology provided a 'robust framework' for the development of infrastructure priority lists, and that 'a clear strength in the process employed in developing the first Infrastructure Priority List was the rigorous approach adopted to analysing proponent submissions against the published criteria'. See ANAO Audit Report No.2 2010–11, *Conduct by Infrastructure Australia of the First National Infrastructure Audit and Development of the Infrastructure Priority List*, Canberra, 23 July 2010, pp. 20 – 23.

¹¹⁸ Central agencies were aware of the program eligibility and merit criteria.

3.63 DEWHA became aware of the decision to award NUWDP funding towards an expanded ADP some days after the decision was taken. In a subsequent briefing to its then Minister, the department referred the Minister to its earlier assessment that a \$100 million grant towards a 50GL per annum ADP satisfied the NUWDP criteria, and advised that the 'expanded plant would also meet these criteria' and also suggested that the decision to award funding be explained, in part, by the then Minister stating that the proposal had been assessed outside the NUWDP competitive process but against the program criteria. However, DEWHA had not obtained the information from South Australia that would be necessary to assess the 100GL per annum ADP proposal in terms of the NUWDP program criteria, and had not examined the expansion project against the NUWDP program guidelines. The department's advice as to how to explain the decision to award funding was not sound, noting that:

- the awarding of further funding to the ADP was inconsistent with the competitive bidding process outlined in the NUWDP program guidelines. The only exceptions to this process requirement related to five named election commitment projects which had been the subject of a specific government decision that they be progressed through the NUWDP. The first \$100 million grant to the ADP had satisfied the election commitment in respect to the Australian Government making a financial contribution to a desalination plant for Adelaide. Under the published program guidelines¹¹⁹, any further grant required consideration in the context of the competitive major projects funding round that was underway at the time the South Australian Government approached the then Prime Minister seeking funding for the expansion project;
- the size of the grant (\$228 million, representing 50 per cent of the estimated project costs) was significantly greater than permitted under the program guidelines (which limited NUWDP funding contributions to 10 per cent of eligible capital costs, to a maximum of \$100 million); and

¹¹⁹ ANAO's grants administration Better Practice Guide notes that departing from the selection process and/or criteria outlined in the published guidelines may be detrimental to the conduct of a transparent and equitable grant program. Further in this respect, the Commonwealth Grant Guidelines advise that, in the interests of transparency, accountability and equity, the program guidelines should document any circumstances in which it might be considered necessary to waive or amend the eligibility or assessment criteria established for a granting activity.

- the grant proposal did not demonstrably satisfy three of the five merit assessment criteria. Specifically:
 - constructing a 100GL per annum ADP provided increased water security/insurance compared with that provided by a 50GL per annum plant. However, in respect to the first of the NUWDP’s merit criteria relating to water supply security, information provided to DEWHA in relation to the \$100 million grant proposal had outlined that the ADP expansion was expected to provide increased insurance in terms of long-term (between 2025 and 2050) water security but water from an expanded plant was not expected to be needed in the short-term¹²⁰ either in average years or drought years;
 - based on Infrastructure Australia’s analysis, the project was not cost-effective, meaning the project did not meet the second merit criterion¹²¹; and
 - in respect to the third merit criterion relating to the cost-effectiveness of an Australian Government contribution, the evidence is that the 100GL expansion project was proceeding irrespective of whether Australian Government funding was awarded and, in seeking funding, South Australia did not offer to commit to provide any environmental benefits in return for Australian Government funding of the proposal.¹²²

¹²⁰ SA Water’s application for funding towards the 50GL per annum plant advised that a plant with this capacity was expected to reduce the risk of level 5 water restrictions from a 1 in 45 year chance without a 50GL per annum ADP to 1 in 230 years with a 50 GL per annum ADP.

¹²¹ There was a close alignment between the Infrastructure Australia assessment methodology (which the ADP expansion proposal had been assessed as not meeting) and one of the NUWDP merit criteria. Specifically, the BAF evaluation criterion not met related to a proposal demonstrating, through a thorough cost-benefit analysis, that it represents good value for money. This criterion was closely aligned with the published methodology for compiling the Infrastructure Priority List, which had outlined that objective cost-benefit analysis (through Benefit Cost Ratios, BCRs) would be used as the ‘primary driver’ of decision-making (and Infrastructure Australia had assessed that the BCR for the ADP expansion proposal was too low to support being included on the Infrastructure Priority List). Similarly, the second NUWDP merit criterion was ‘cost-effectiveness of the project’ with the program guidelines stating that, in terms of this criterion, proposals should include cost-benefit analysis.

¹²² However, both before and after funding was approved, DEWHA had suggested that South Australia should be required to provide environmental water as part of the conditions of the grant. Accordingly, the announcement of the grant included a statement that funding would be provided on the basis that the expanded project would deliver improved water security for Adelaide and a reduced reliance on the Murray River, along with environmental benefits. In this respect, the NUWDP program guidelines included a merit criterion titled ‘environmental benefits’, with the guidelines outlining that proposals for NUWDP funding should describe ‘for projects that generate water savings for environmental flows, how they intend to preserve and manage those flows over the long term’.

3.64 In response to a number of ANAO performance audit reports that have noted continuing shortcomings in adherence to the requirement for spending decisions to be informed by agency advice on the merits of proposed grants relative to the program guidelines, updated Commonwealth Grant Guidelines (CGGs) (to take effect from 1 June 2013) will introduce more specific briefing requirements. These requirements seek to improve the information provided to Ministers and consistency in briefing practices across government. Among other matters, the updated CGGs state that an agency is required, as a minimum to:

- explicitly note that the spending proposal being considered is a 'grant';
- provide information on the applicable requirements of the FMA Act and Regulations, the CGGs (particularly any ministerial reporting obligations), including the legal authority for the grant;
- outline the application and selection processes, including the selection criteria, that were used; and
- include the merits of the proposed grant or grants relative to the grant guidelines and the 'key consideration' of achieving value with public money.

4. Grant Management Arrangements

This chapter examines the agreements signed for the two grants, including the development of an arrangement to implement the funding condition in respect to the second grant for a reduction in Adelaide's reliance on the River Murray.

Background

4.1 The agreement entered into with a grant funding recipient provides the means by which the responsible agency gives effect to the decision-maker's approval of a grant. In this context, the CCGs advise¹²³ agencies that:

- well-drafted funding agreements are necessary for the effective management of grants activities and contribute to good governance and accountability;
- while no form of funding agreement is right for all circumstances, an enforceable agreement should be established wherever possible. The forms of enforceable agreements include: a deed, a contract, conditional gift and an exchange of letters;
- unless legislation or policy mandates the form of an agreement, agencies should choose the appropriate form of agreement based on: an analysis of the risks; the context in which the grant is made; the desired remedy for non-compliance; and legal advice, where appropriate; and
- whatever form of funding agreement is chosen, it should protect the Commonwealth's interests in ensuring that public money is used for the intended purpose, define project deliverables, schedule payments (according to progress), and specify progress reporting requirements and acquittal procedures.

4.2 Attached to the NUWDP program guidelines was a standard funding agreement for the program. The standard funding agreement set out the terms and conditions under which NUWDP funding would be provided, with project-specific milestones to be set out in a schedule attached to the agreement and project payments to be linked to those milestones. The schedule was also to include financial reporting requirements, including a requirement for a final report to be provided at the completion of the project together with a final,

¹²³ This guidance in the CCGs was drawn from the 2002 version of ANAO's grants administration Better Practice Guide.

independently audited financial statement. Further, the second eligibility criterion required that project proponents must 'accept the terms and conditions of the standard funding agreement'.

4.3 In this context, ANAO examined the development of the governance documents adopted for each grant made towards the construction of the ADP, and the steps taken to satisfy a condition applied to the second grant.

Development of documents to govern the provision of funding

4.4 In its December 2008 application for NUWDP funding for the 50GL per annum ADP, SA Water stated as follows:

Yes, SA Water accepts the terms and conditions of the standard funding agreement.

The sample standard funding agreement provided by DEWHA is being reviewed by SA Water and Crown Solicitor's Office. SA Water holds the right to reserve judgement until legal advice is sought. SA Water will proceed with the application in good faith subject to these findings. There may also be elements of the application which SA Water would regard as confidential and exemptions from confidentiality may be required.

4.5 Accordingly, following the 23 March 2009 decision by the then Minister for Climate Change and Water to approve the \$100 million grant, DEWHA and SA Water commenced negotiations in April 2009 to establish contractual arrangements through a funding agreement for the delivery of the 50GL per annum ADP. Following the approval of funding by the SPBC on 28 April 2009, governance arrangements for the \$228 million grant for the 100GL per annum ADP expansion was subsequently included in these negotiations. The negotiations were premised on funding being provided to SA Water to deliver the project, as SA Water was the South Australian government entity responsible for the design and delivery of the ADP.

4.6 Prior to and during the negotiation of the funding agreement, changes were being made to the way in which funding was distributed from the Commonwealth to States/Territories. In this regard, the federal financial framework consisting of the *Federal Financial Relations Act 2009* (FFR Act), the *COAG Reform Fund Act 2008* and the corresponding Intergovernmental

Agreement was introduced on 1 January 2009.¹²⁴ Under this framework, payments classified as payments to and through the states for general and specific purposes are made centrally through the Department of the Treasury (Treasury). The federal financial framework provides ongoing financial support for the delivery of services by the states through:

- (a) general revenue assistance, including GST payments and other general revenue assistance, to be used by the states for any purpose; and
- (b) payments for specific purposes, comprising:
 - National Specific Purpose Payments to be spent by the states in key service delivery sectors (examples of which include healthcare, schools, skills and workforce development, affordable housing and disability services); and
 - National Partnership payments to support the delivery of specified outputs or projects, to facilitate reforms or to reward the states for nationally significant reforms.¹²⁵

4.7 The correct classification of payments is important as it determines how each payment is reported in the Australian Government's budget and related papers, and which Commonwealth agency is responsible for making and reporting the payment in financial statements.¹²⁶ Payments are classified as either:

- payments to and through the states and territories for general and specific purposes, which are made centrally by Treasury through the federal financial framework arrangements and reported in Budget Paper No.3, Australia's Federal Relations; or
- Commonwealth own-purpose expenses (COPEs), which are expenses made by the Australian Government in the conduct of its own general government sector activities. COPEs may involve payments to other levels of government, in which case the payments are made and reported by the responsible agency.

¹²⁴ The FFR Act commenced on 1 April 2009 and applied to payments in the 2008–09 financial year payable from 1 January 2009. Guidance on the operation of the new federal financial framework was issued by the Department of the Treasury on 3 April 2009 (see Federal Finances Circular No. 2009/03).

¹²⁵ Department of Finance and Deregulation, Finance Circular 2010/02, *Classification of Payments to the States and Territories and Commonwealth Own-Purpose Expenses*, 14 October 2010.

¹²⁶ *ibid.*

4.8 For project-specific payments to a state government entity that are in the nature of a grant, the issue of classification is of particular importance in determining the governance arrangements that will apply to the payment. Specifically:

- payments that are classified as payments to or through the states must be delivered through the federal financial relations framework. In the case of project-specific payments, this will usually occur through a National Partnership Agreement. Since 1 July 2009, such payments have been excluded from the coverage of the grants administration framework¹²⁷; whereas
- payments that are classified as COPEs are not captured by the federal financial relations framework, regardless of whether the funding recipient is a state government entity. Such payments are subject to the grants administration framework and are able to be delivered through a legally enforceable funding agreement.

4.9 Two criteria are used to determine whether payments made to other levels of government are recognised as COPEs, being:

- contestability: where the funding is contestable, in that it is available to all sectors of the economy, payments will be classified as COPEs. By way of comparison, where the funding is restricted to other levels of government or particular entities in areas of state government responsibility (such as public hospitals, schools and local councils), it is classified as payments to or through the states or direct to local government¹²⁸; and
- the nature of the transactions: where other governments have responsibility for the activity, the payments will not typically be considered a COPE.¹²⁹

4.10 In a number of audit reports, ANAO has identified instances where payments have been incorrectly and/or inconsistently classified such that some

¹²⁷ With effect from 1 July 2009, FMA Regulation 3A(2) stipulates a number of arrangements that are taken not to be grants and to which, therefore, the CGGs do not apply. This includes a payment to a State or Territory that is made for the purposes of the FFR Act, including General Revenue Assistance, Other General Revenue Assistance, National Specific Purpose Payments and National Partnership Payments.

¹²⁸ Payments to local government entities are only excluded from the coverage of the grants administration framework where they involve a payment that is made for the purposes of the *Local Government (Financial Assistance) Act 1995* (see FMA Regulation 3A(2)(i)).

¹²⁹ Finance Circular 2010/02, op. cit.

grants under a program have been governed by a funding agreement, whereas amounts paid to some recipients have been governed by a National Partnership Agreement. ANAO has suggested that there would be benefits in the interaction of the grants administration and FFR frameworks being clarified. Similarly, in its Report No. 427, the Joint Committee of Public Accounts and Audit (JCPAA) recommended that Finance examine the interaction between the new grants framework and grant payments delivered under the FFR framework, and proposed options to remove inconsistencies and improve governance arrangements for all grants provided to States and Territories. The Government response indicated that application of the FFR framework should not result in situations where some of the funding awarded under a grant program is delivered through funding agreements with other funding administered through a NPA.¹³⁰ Specifically, the JCPAA was advised that:

Where States obtain Commonwealth grant funding through programs that are not covered by the IGA FFR, for example, through competitive or targeted grant processes, it is appropriate that they are subject to the same accountability requirements as other grant recipients. While this may result in different accountability requirements for the States depending on whether funding is received through the IGA FFR process or from grant programs covered by the CGGs, this appropriately reflects the different nature of program funding and the level of autonomy and discretion involved.¹³¹

4.11 By design, the NUWDP is a contestable program in that funding is available to all sectors of the economy. Accordingly, all grants under the NUWDP should be governed by funding agreements, and payments made directly by DEWHA to the project proponent (including in respect to projects being undertaken by state government entities). However, funding for three NUWDP projects (including the ADP¹³²) was transferred from DEWHA to Treasury in April 2009 so that payments could be made by Treasury to the relevant state government treasury departments under the FFR framework. Against this background, in March 2013 DSEWPaC advised ANAO that it

¹³⁰ Australian Government Response to the Joint Committee of Public Accounts and Audit Report No. 427, *Inquiry into National Funding Agreements*, Senate Hansard, Thursday 16 August 2012, p. 67.

¹³¹ Australian Government Response to the Joint Committee of Public Accounts and Audit Report No. 427, *Inquiry into National Funding Agreements*, Senate Hansard, Thursday 16 August 2012, p. 67.

¹³² The other two projects were the Glenelg to Adelaide Parklands Water Recycling Project and the Geelong Shell Water recycling project in Victoria.

considered the use of NPAs for the ADP funding (and two other projects – see footnote 132) to be appropriate and that:

The department received advice from Treasury to the effect that for competitive grants we were to use funding agreements, but direct funding to states should be provided by way of National Partnership Agreements. This advice was conveyed to the then Minister for Climate Change and Water and Parliamentary Secretary for Water.

4.12 As a result of the decision that payments should be made under the FFR framework, DEWHA ceased work on negotiating a funding agreement with SA Water and, instead, two implementation plans were made under the National Partnership Agreement on Water for the Future that was finalised in September 2009. Specifically an Implementation Plan for the:

- 50GL per annum grant of \$100 million was agreed to by the then Minister for Climate Change and Water on 11 February 2010; and
- 100GL per annum grant of \$228 million was agreed by the Parliamentary Secretary for Sustainability and Urban Water and the Minister for Sustainability, Environment, Water, Population and Communities on 26 July 2011.

4.13 The use of the NPA framework for the ADP grants:

- has led to a degree of inconsistency within the program in terms of the arrangements adopted to govern the oversight of projects and the making of project payments. For example, while a funding agreement was entered into with SA Water for the Glenelg to Adelaide Parklands Water Recycling Project, two Implementation Plans with South Australia have been established to provide funding via the state treasury to SA Water for the construction of the ADP¹³³;
- delayed the finalisation of grant governance arrangements. Specifically, rather than tailoring the schedule to the standard NUWDP funding agreement to reflect the terms of each of the two ADP grants (which the program guidelines had indicated should occur within 12 weeks of a funding offer being made), DEWHA had to await the finalising of the

¹³³ Similarly, an Implementation Plan was entered into with Victoria for the Geelong Shell water recycling project, but a funding agreement was used with a corporation owned by the Victorian Government (City West Water Limited) for another project.

Water for the Future NPA (which was finalised in September 2009) and then negotiate an Implementation Plan in respect to each grant;

- resulted in the grants being provided to an ineligible project proponent¹³⁴; and
- would have resulted in the grants administration framework outlined in the CGGs not applying to the processes by which funding was sought, assessed and awarded (and with no associated grants reporting obligations to be met) had the grants been awarded after 1 July 2009.¹³⁵

Framework to achieve environmental benefits as a result of the expansion grant

4.14 After the SPBC funding decision, and consistent with DEWHA advice, it was agreed between the then Minister for Climate Change and Water and the then Prime Minister that the \$228 million in funding would be provided on the basis that the project delivers improved water security for Adelaide and a reduced reliance on the River Murray, along with environmental benefits. Accordingly, the second milestone in the Implementation Plan for the \$228 million grant (no payment was associated with this milestone) required:

Agreement of the Murray Darling Basin Authority of a framework that ensures that the 6 gigalitre high reliability entitlement and the Environmental Provision will be available to offset the South Australian sustainable diversion limit established by the Basin Plan.

Agreement of the Commonwealth Department of Sustainability, Environment, Water, Population and Communities to an annual reporting format for the environmental water arrangements agreed in Schedule 1.¹³⁶

4.15 Subsequently, securing water for environmental flows became a focus for negotiations over the implementation of the \$228 million grant. However, obtaining an acceptable proposal from South Australia was challenging, given that:

¹³⁴ The NUWDP program guidelines specified that to be eligible, the project proponent 'must be a body incorporated in Australia, including a statutory corporation, a body corporate, or a corporation sole (project proposals submitted by consortia will be considered only if they identify a lead proponent with whom the funding agreement is to be entered)'. SA Water met this criterion, but state government departments do not.

¹³⁵ See footnote 127.

¹³⁶ The reporting format was agreed on 23 August 2012.

- funding was obtained other than through a competitive funding round (the competitive tension of a funding round can provide an incentive for project proponents competing for funding to offer maximum benefits in return for an Australian Government funding contribution in order for their grant proposal to be ranked more highly than other competing proposals);
- the South Australian Government had not offered to commit to reducing its draw on the Murray River when seeking Australian Government funding for the expansion project¹³⁷; and
- the amount and nature of the environmental benefits expected was not discussed or agreed with South Australia prior to funding being awarded, and the funding condition did not require a specific level of water savings to be provided.

4.16 Against this background, it took a considerable period of time and numerous meetings and exchanges of correspondence (both between senior officials and at ministerial level) to obtain a proposal from South Australia concerning the environmental benefits condition. As it eventuated, it was not until April 2011 that the Parliamentary Secretary for Sustainability and Urban Water and the Minister for Sustainability, Environment, Water, Population and Communities were advised by DSEWPaC to accept a proposal from the South Australian Government that met the funding condition.¹³⁸

4.17 DEWHA, and subsequently DSEWPaC, examined whether the quantum and nature of the environmental water offered by South Australia represented a reasonable return given the amount of funding being contributed to the construction of the ADP by the Australian Government. As it eventuated, in its April 2011 advice to the Parliamentary Secretary and Minister that the South Australian Government's proposal should be accepted, DSEWPaC observed that:

The first key issue is whether the volume of the environmental provision could be higher. The department has indicated during discussions that, given the size of the plant and Australian Government funding, that a higher volume of

¹³⁷ Similarly, in respect to the \$100 million grant proposal for the 50GL per annum plant, DEWHA's assessment provided to the then Minister for Climate Change and Water had commented that: 'The proponent also claims there will be some environmental benefit through a reduction in pumping from the River Murray, however, this has not been quantified.'

¹³⁸ The time taken to obtain an acceptable proposal from South Australia was also reflected in the significant (more than two year) delay from the grant funding decision in April 2009 to July 2011 for the Implementation Plan for the \$228 million grant to be finalised and agreed.

water should be provided. However, we also note that the funding was for the expansion of the plant and water security for Adelaide. The department believes that South Australia is not likely to agree to a higher volume of water than the current proposal.

4.18 Similar advice was included in the Minister's 11 April 2011 correspondence to the Prime Minister seeking her agreement to the South Australian Government's proposal to meet the funding condition. The Prime Minister was also advised that:

...the primary purpose of the desalination plant is to provide water security for Adelaide.

4.19 On 16 November 2012, South Australia wrote to the Murray Darling Basin Authority outlining a proposed framework to account for the environmental water provided for by the Implementation Plan for the \$228 million grant. On 30 November 2012, the Authority agreed to the framework for the accounting of environmental water to be delivered under the Implementation Plan. The Authority also noted that additional work would need to be undertaken by South Australia to finalise the delivery methodology under the framework.

Conclusion

4.20 The program guidelines required that NUWDP grants be governed by a legally enforceable funding agreement, and DEWHA initially sought to develop a funding agreement with SA Water. However, as it eventuated, the two ADP grants are governed by Implementation Plans under the Water for the Future National Partnership Agreement. The change in approach occurred as a result of a misunderstanding of the new Federal Financial Relations Framework at the time it was being introduced. Among other adverse effects, the decision to adopt Implementation Plans under a National Partnership Agreement contributed to delays in the finalisation of governance arrangements for the grant funding (the Implementation Plans were not agreed until February 2010, for the \$100 million grant, and July 2011, for the \$228 million grant).

4.21 However, the most significant factor in the delay in finalising the governance arrangements for the \$228 million grant related to South Australia meeting the funding condition adopted after the SPBC approval of the grant, which required that the expanded ADP provide environmental benefits. Considerable effort was made by senior DEWHA (and, subsequently,

DSEWPaC) officials as well as at ministerial level to obtain a proposal from South Australia that would meet the funding condition. Obtaining an acceptable proposal from South Australia was challenging given that the following circumstances placed the Commonwealth in a difficult negotiating position:

- funding was obtained by South Australia other than through a competitive funding round (a process that can provide an incentive for project proponents to offer maximum benefits in return for an Australian Government funding contribution in order for their grant proposal to be ranked more highly than other competing proposals);
- the South Australian Government had not offered to commit to reducing its draw on the Murray River when seeking Australian Government funding for the expansion project; and
- the amount and nature of the environmental benefits expected was not discussed or agreed with South Australia prior to funding being awarded, and the funding condition did not require a specific level of water savings to be provided.



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Auditor-General

Canberra ACT
7 May 2013

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