

Defence's Management of Contracts for the Supply of Munitions — Part 1

Department of Defence

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Canberra ACT

25 June 2024

Dear President
Dear Mr Speaker

In accordance with the authority contained in the *Auditor-General Act 1997*, I have undertaken an independent performance audit in the Department of Defence. The report is titled *Defence's Management of Contracts for the Supply of Munitions — Part 1*. I present the report of this audit to the Parliament.

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

Yours sincerely

A handwritten signature in black ink, which appears to read 'Rona Mellor', is positioned below the 'Yours sincerely' text.

Rona Mellor PSM
Acting Auditor-General

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

AUDITING FOR AUSTRALIA

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Audit snapshot

Auditor-General Report No.47 2023–24

Defence's Management of Contracts for the Supply of Munitions — Part 1



Why did we do this audit?

- ▶ The implementation of a Guided Weapons and Explosive Ordnance (GWEO) enterprise was announced as a key government priority in the 2023 *Defence Strategic Review*, and the domestic manufacture of GWEO and munitions was one of seven Sovereign Defence Industrial Priorities announced by the Australian Government in the *Defence Industry Development Strategy* in April 2024.
- ▶ This audit provides independent assurance to the Parliament on Defence's establishment of a 10-year agreement with Thales from July 2020 for the continued management and operation of the Mulwala and Benalla facilities. It builds on previous ANAO work examining Defence's management of the facilities over time.



Key facts

- ▶ The Mulwala and Benalla facilities are Commonwealth-owned and have been operated by a third party (Thales Australia) since 1999.
- ▶ The current contract, the Strategic Domestic Munitions Manufacturing (SDMM) contract, replaced a five-year interim contract, which was established after a competitive process was terminated in 2014.



What did we find?

- ▶ Defence's conduct of the sole source procurement for the operation and maintenance of the Mulwala and Benalla facilities beyond June 2020 was partly effective.
- ▶ Defence's planning for the operation and maintenance of the facilities beyond the expiry of the 2015–20 interim contract was partly effective.
- ▶ Defence's conduct of the sole source procurement process to establish the 2020–30 contractual arrangements was partly effective.
- ▶ Defence's management of probity was not effective and there was evidence of unethical conduct.



What did we recommend?

- ▶ There were eight recommendations to Defence aimed at improving: procurement planning; advice to decision-makers; management of probity risks and issues; compliance with record keeping requirements; and traceability of negotiation directions and outcomes.
- ▶ Defence agreed to the eight recommendations.

\$1.2 bn

contract price (GST exclusive) at
31 March 2024.

\$108 m

value (GST inclusive) of reported
contract variations (relating to
survey and quote work orders) at
19 June 2024.

\$225 m

minimum munitions order value
(GST exclusive) under the
contract.

Summary and recommendations

Background

1. The Mulwala facility in New South Wales is the sole remaining manufacturing site of military propellants and high explosives in Australia. The nearby munitions facility at Benalla, Victoria, uses some of the output of the Mulwala facility in its operations. Both facilities are owned by the Commonwealth and operated by a third party, Australian Munitions, a wholly owned subsidiary of Thales Australia (Thales).¹ Thales has managed and operated the facilities at Benalla and Mulwala under several different contractual arrangements since 1999 (outlined in Appendix 3).
2. The Australian Government announced on 29 June 2020 that the Department of Defence (Defence) had signed a new 10-year agreement valued at \$1.2 billion with Thales for the continued management and operation of the Mulwala and Benalla facilities.² The agreement was intended to provide surety of supply of key munitions and components for the Australian Defence Force (ADF) and maintain a domestic munitions manufacturing capability. The agreement took effect on 1 July 2020 and resulted from a complex multi-year sole source procurement begun in 2016. The sole source procurement followed a terminated competitive procurement process undertaken between 2009 and 2014.
3. The Australian Government also announced on 29 June 2020 a new contract between the Commonwealth and NIOA Munitions (NIOA) for a tenancy at the Benalla munitions factory.³ This agreement was to establish NIOA as a tenant alongside Thales and provide opportunities for domestic manufacturing while enhancing supplies of key munitions for Defence.⁴
4. On 24 April 2023, the Australian Government released a public version of the final report of the *Defence Strategic Review* (DSR).⁵ It referenced the continuing importance of advanced munitions manufacturing, stating that the immediate focus must be on consolidating ADF guided weapons and explosive ordnance (GWEO) needs, establishing a domestic manufacturing capability, and the acceleration of foreign military and commercial sales. The report further outlined that, to

1 For convenience, this report refers to Australian Munitions/Thales Australia as Thales. Australian Munitions commenced trading on 2 November 2012. Prior to this, Thales managed and operated the facilities through ADI Limited, which became a wholly owned subsidiary of Thales Australia in 2006.

2 Minister for Defence and Minister for Defence Industry, 'Securing domestic manufacturing capability for Australian Defence Force munitions', joint media release, 29 June 2020, available from <https://www.minister.defence.gov.au/media-releases/2020-06-29/securing-domestic-manufacturing-capability-australian-defence-force-munitions> [accessed 25 May 2023].

The contract price relates to the 10-year initial contract term and does not include the cost to Defence of additional tenure able to be awarded on the basis of satisfactory contractor performance at the seven-year mark (three years tenure) and nine-year mark (two years tenure).

3 Minister for Defence and Minister for Defence Industry, 'Boosting munitions manufacturing capability in Australia', joint media release, 29 June 2020, available from <https://www.minister.defence.gov.au/media-releases/2020-06-29/boosting-munitions-manufacturing-capability-australia> [accessed 11 October 2023].

4 For convenience, this report refers to NIOA Munitions/NIOA Nominees Pty Ltd as NIOA. The contract with NIOA commenced on 1 July 2020 and had an original reported value on AusTender of \$4.1 million. By 19 June 2024, there had been 22 amendments recorded on AusTender. These amendments related to survey and quote work orders and the reported value had increased to \$12.8 million. See <https://www.tenders.gov.au> [accessed 18 April 2024].

5 Department of Defence, *Defence Strategic Review*, 24 April 2023, available from <https://www.defence.gov.au/about/reviews-inquiries/defence-strategic-review> [accessed 11 October 2023].

do this, the ADF must hold sufficient stocks of GWEO and have the ability to manufacture certain lines, with the realisation of a GWEO enterprise being ‘central to achieving this objective.’⁶

5. At 19 June 2024, the implementation of a GWEO enterprise remains a key government priority, with the domestic manufacture of GWEO and munitions in Australia included: as one of seven ‘Sovereign Defence Industrial Priorities’ in the *Defence Industry Development Strategy* (announced in February 2024)⁷; and as part of the ‘immediate priorities’ set out in the public versions of the *2024 Integrated Investment Program* (IIP) and the *2024 National Defence Strategy* (both announced on 17 April 2024).⁸

6. On 5 May 2023, the Minister for Defence Industry announced the appointment of a senior responsible officer with responsibility for a Defence GWEO enterprise.⁹ At June 2024, Defence’s website stated that the facilities at Mulwala and Benalla ‘are key assets within the GWEO enterprise and will play a role in the expansion of domestic GWEO manufacturing.’¹⁰

Rationale for undertaking the audit

7. To establish the arrangements for the operation and maintenance of the Mulwala and Benalla facilities beyond June 2020, Defence undertook a complex and lengthy procurement process that was based on a sole source approach. This audit examined whether this process was effective and in accordance with the *Commonwealth Procurement Rules* (CPRs).

8. This audit builds on previous work by the ANAO which has examined Defence’s management of the Benalla and Mulwala facilities over time, and provides independent assurance to the Parliament on Defence’s establishment of arrangements for the operation and maintenance of the Mulwala and Benalla facilities beyond June 2020.

Audit objective and criteria

9. The audit objective was to assess whether the arrangements for the operation and maintenance of the Mulwala and Benalla facilities beyond June 2020 were established through appropriate processes and in accordance with the CPRs.

6 Department of Defence, *Defence Strategic Review*, 24 April 2023, p. 68.

7 See: Minister for Defence Industry and International Development and the Pacific, ‘Landmark strategy to maximise support for Defence industry’, media release, 29 February 2024, available from <https://www.minister.defence.gov.au/media-releases/2024-02-29/landmark-strategy-maximise-support-defence-industry> [accessed 29 February 2024] and Department of Defence, *Defence Industry Development Strategy*, 29 February 2024, pp. 18–19, available from <https://www.defence.gov.au/about/strategic-planning/defence-industry-development-strategy> [accessed 29 February 2024].

8 See Department of Defence, *Integrated Investment Program*, 17 April 2024, pp. 15–16, available from <https://www.defence.gov.au/about/strategic-planning/2024-national-defence-strategy-2024-integrated-investment-program> [accessed 22 April 2024]; Department of Defence, *National Defence Strategy*, 17 April 2024, p. 38, available from <https://www.defence.gov.au/about/strategic-planning/2024-national-defence-strategy-2024-integrated-investment-program> [accessed 22 April 2024].

9 Minister for Defence Industry and International Development and the Pacific, ‘Moving ahead to manufacture long-range weapons and munitions in Australia’, media release, 5 May 2023, available from <https://www.minister.defence.gov.au/media-releases/2023-05-05/moving-ahead-manufacture-long-range-weapons-and-munitions-australia> [accessed 18 June 2024].

10 See: <https://www.defence.gov.au/project/gweo> [accessed 4 January 2024].

10. To form a conclusion against the audit objective, the following high-level criteria were selected:

- Did Defence plan effectively for the operation and maintenance of the facilities beyond the expiry of the 2015–20 interim contract?
- Did Defence conduct an effective sole source procurement process to establish the 2020–30 contractual arrangements?
- Did Defence effectively manage probity throughout the process?

11. This report is the first of two performance audit reports examining Defence's establishment and management of the facilities beyond June 2020. It focuses on Defence's establishment of the 2020–30 operating arrangements, including the tender assessment process, advice to decision makers and the decision to conduct a sole source procurement. Defence's management of performance against the contract is the focus of a second report, which will be presented for tabling later in 2024.

Conclusion

12. Defence's conduct of the sole source procurement for the operation and maintenance of the Mulwala and Benalla facilities beyond June 2020 was partly effective. Defence's management of probity was not effective and there was evidence of unethical conduct.

13. Defence's planning processes prior to the expiry of the 2015 interim contract were partly effective. While options for the management of the facilities beyond June 2020 were developed, deficiencies were identified in Defence's subsequent procurement and probity planning processes and in its advice to decision-makers. Defence's decision to conduct a sole sourced procurement was not informed by an estimated value of the procurement prior to this decision and Defence did not document the legal basis for selecting a sole sourced procurement approach, as required by the CPRs. Probity risks were realised in 2016 when Defence personnel provided Thales with confidential information relating to its Investment Committee (IC) proposal, and advice to decision-makers did not address how value for money would be achieved and commercial leverage maintained in the context of a sole source procurement.

14. Defence's conduct of the sole source procurement process to establish the 2020–30 contractual arrangements was partly effective. Risk assessments were not timely and appropriate records for key meetings with Thales during the tender process were not developed or retained by Defence. After assessing Thales' tender response as not being value for money in October 2019, Defence proceeded to contract negotiations in December 2019 notwithstanding internal advice that Defence was at a disadvantage in such negotiations due to timing pressures.

15. The negotiated outcomes were not fully consistent with Defence's objectives and success criteria. Defence's approach to negotiating the contract in accordance with high-level issues reduced the line of sight between the request for tender (RFT) requirements and the negotiated outcomes. Defence's advice to ministers on the tender and contract negotiations did not inform them of the extent of tender non-compliance, basis of the decision to proceed to negotiations, or 'very high risk' nature of the negotiation schedule.

16. Defence did not establish appropriate probity arrangements in a timely manner. A procurement-specific probity framework to manage risks associated with the high level of

interaction between Defence and Thales was not put in place until July 2018. Probity risks arose and were realised during 2016 and 2017, including when a Defence official solicited a bottle of champagne from a Thales representative. Defence did not maintain records relating to probity management and could not demonstrate that required briefings on probity and other legal requirements were delivered.

Supporting findings

Planning during the interim contract period

Options development and consideration of facilities management beyond June 2020

17. Defence provided advice to the Minister for Defence during 2014 on a range of options for the management of the facilities beyond June 2020, including: continuing with the status quo; the Commonwealth operating the facilities; and closing the facilities. These options continued to be considered by Defence and the government between 2015 and mid-2017. In 2016, a clear preference emerged to sole source the operation and maintenance of the facilities to the incumbent, Thales. By July 2016, Defence was primarily focused on developing a proposed 'strategic partnership' arrangement with Thales. Defence did not document the legal basis (that is, an exemption provided by paragraph 2.6 of the CPRs) for the proposed sole source activity to inform its subsequent procurement planning (see paragraphs 2.1 to 2.51).

18. A procurement-specific probity framework was not put in place until July 2018, to help manage probity risks in the context of pursuing a strategic partnership arrangement with Thales. These risks crystallised during 2016 when:

- senior Defence personnel advised Thales at an October 2016 summit meeting that Defence's preference would be to progress a government-owned contractor-operated arrangement with Thales into the future.
- a Defence official sought assistance from and provided information to Thales in November 2016 on the development of internal advice to the IC, Defence's committee processes, and internal Defence thinking and positioning. Government information of this sort is normally considered confidential, and the relevant email exchange evidenced unethical conduct (see paragraphs 2.48 to 2.51).

Advice and analysis informing the decision to conduct a sole source process with the incumbent operator

19. Defence's advice to the IC in December 2016 and the Minister for Defence Industry in mid-2017 on the decision to sole source was not complete. The advice did not address the legal basis for the procurement method, the risks associated with a sole source procurement approach, or value for money issues — including how Defence expected to achieve value for money and maintain commercial leverage in the context of a sole source procurement. When the IC approved the sole source procurement method in December 2016, Defence had not estimated the value of the procurement. This was not consistent with the CPR requirement to estimate the value of a procurement before a decision on the procurement method is made (see paragraphs 2.52 to 2.71).

Establishment of the 2020–30 arrangements

Procurement planning activities

20. Defence's procurement planning activities were not timely. Prior to mid-2017, Defence's planning had largely focussed on seeking approval by June 2017 to inform Thales of the arrangements for the facilities beyond June 2020 (as required of Defence under the interim contract) and to enable collaborative contract development with Thales to commence. Defence's advice to decision-makers was not informed by the results of key planning processes, as required by the CPRs and Defence's procurement policy framework. These key processes were not conducted until after December 2016, when the sole source procurement method was approved and included:

- the progressive development of Defence's requirements for the facilities between March 2017 and July 2019, with assistance from Thales; and
- internal workshops between October 2017 and May 2018, which identified risks that had not been previously documented. Defence did not develop a risk management plan to actively manage those risks (see paragraphs 3.1 to 3.31).

Development of the request for tender

21. Defence undertook a process which included the principal elements of a complex procurement as set out in Defence's procurement policy framework, including an Endorsement to Proceed (EtP), RFT process and detailed contract negotiations. A feature of Defence's process was the high level of interaction with Thales on the contents of the RFT before and after it was issued on 16 August 2019, including during the tender response period. Defence's Complex Procurement Guide (CPG) identified 'probity risks inherent in such activities' and stated that relevant engagement processes and activities 'should be planned and conducted with appropriate specialist support.' Seeking specialist advice on the propriety and defensibility of its approach would have been prudent and consistent with the *Public Governance, Performance and Accountability Act 2013* (PGPA Act) duty that officials exercise care and diligence (see paragraphs 3.32 to 3.63).

Tender evaluation

22. By October 2019, Defence had determined that Thales' tender response was not value for money due to assessing the proposal as 'Deficient – Significant' with 'High' risk against all five evaluation criteria and identifying 199 non-compliances against the RFT. Defence considered the number of non-compliances to be 'unprecedented' and initially agreed, internally, to extend the interim contract with Thales to allow sufficient time to negotiate the non-compliances with the RFT (see paragraphs 3.64 to 3.78).

23. Following senior-level discussions in November 2019 with Thales, Defence decided to conclude the evaluation process on 4 December 2019 and proceed to contract negotiations. This decision was made notwithstanding internal advice that Defence was at a disadvantage in negotiations due to timing pressures. Defence's internal advice considered that it had no 'off-ramps' due to the impending expiry of the interim contract on 30 June 2020. Defence did not clearly document the basis for reducing risk ratings against all the evaluation criteria from 'High' to 'Medium', following the senior-level discussions with Thales (see paragraphs 3.79 to 3.90).

24. Defence did not prepare or retain appropriate records for key meetings with Thales during the tender where the identified risks required active Defence management in the Commonwealth interest. Defence's approach to record keeping was not consistent with requirements in the relevant Communications Plan, internal procurement advice, guidance in the CPG, or the CPRs (see paragraphs 3.91 to 3.100).

Negotiation outcomes

25. The negotiated outcomes for the 2020–30 contract were not fully consistent with Defence's objectives and success criteria approved by Defence in July 2019. At the conclusion of negotiations in February 2020, three of the 15 success criteria aimed at incentivising satisfactory performance and reducing the contract management burden and total cost of ownership for the facilities were reported as not achieved. Defence's approach to negotiations involved agreeing a schedule and high-level negotiation issues with Thales, to guide negotiations between December 2019 and February 2020. Defence did not systematically address the 199 non-compliances it had identified in Thales' tender response. This approach reduced the traceability between the RFT requirements, risks and issues identified during tender assessment, and the negotiated outcomes in the agreed contract (see paragraphs 3.101 to 3.114).

26. Defence's advice to its ministers on the tender and 2020–30 contract negotiations did not inform them of key issues such as the extent of tender non-compliance, the basis of the decision to proceed to negotiations, and Defence's assessment of the 'very high risk' nature of the negotiation schedule (see paragraphs 3.115 to 3.133).

Probity management

Establishment of probity arrangements

27. Defence did not establish appropriate probity arrangements in a timely manner. Defence did not have project and procurement-specific probity arrangements in place until July 2018, more than two years after its initial engagement with Thales (in March 2016) about future domestic munitions manufacturing arrangements. Prior to establishing these probity arrangements, Defence did not assess or take steps to manage potential probity risks arising from ongoing direct engagement with the incumbent operator or remind those involved of their probity obligations, including in relation to offers of gifts and hospitality. During this period, probity risks were realised and there was evidence of unethical conduct, including when a Defence official solicited a bottle of champagne from a Thales representative (see paragraphs 4.1 to 4.30).

28. While Defence's CPG identified 'inherent' probity risks in 'any procurement that involves high levels of tenderer interaction' Defence did not appoint a probity adviser that was external to the department. Defence maintained a register of probity documentation but did not retain relevant records for one of the 65 personnel recorded as having completed documentation. For 22 (25 per cent) of the 87 personnel who completed probity documentation, this completion was not recorded in any register. There was no relevant probity documentation for a further six individuals involved for a period in the procurement. Defence's conflict of interest (COI) register for the procurement was also incomplete. It did not record six instances where a Defence official or contractor declared a potential, perceived or actual COI, including a Tender Evaluation Board member's declaration of long-term social relationships with Thales staff. Defence was unable to

provide evidence that briefings on probity and other legal requirements were delivered in accordance with the Legal Process and Probity Plan for the procurement (see paragraphs 4.31 to 4.50).

Recommendations

Recommendation no. 1
Paragraph 2.31 The Department of Defence document at the time the proposed procurement activities are decided:

- the circumstances and conditions justifying the proposed sole source approach, to inform subsequent procurement planning; and
- which exemption in the CPRs is being relied upon as the basis for the approach and how the procurement would represent value for money in the circumstances.

Department of Defence response: *Agreed.*

Recommendation no. 2
Paragraph 2.61 The Department of Defence, including its relevant governance committees, ensure that when planning procurements, the department estimates the maximum value (including GST) of the proposed contract, including options, extensions, renewals or other mechanisms that may be executed over the life of the contract, before a decision on the procurement method is made.

Department of Defence response: *Agreed.*

Recommendation no. 3
Paragraph 2.64 The Department of Defence, including its relevant governance committees, ensure that advice to decision-makers on complex procurements is informed by timely risk assessment processes that are commensurate with the scale, scope and risk of the relevant procurement.

Department of Defence response: *Agreed.*

Recommendation no. 4
Paragraph 3.61 The Department of Defence ensure that when it undertakes complex procurements with high levels of tenderer interaction, it seeks appropriate specialist advice, including from the Department of Finance as necessary.

Department of Defence response: *Agreed.*

Recommendation no. 5
Paragraph 3.94 The Department of Defence ensure compliance with the Defence Records Management Policy and statutory record keeping requirements over the life of the 2020–30 Strategic Domestic Manufacturing contract, including capturing the rationale for key decisions, maintaining records, and ensuring that records remain accessible over time.

Department of Defence response: *Agreed.*

Recommendation no. 6
Paragraph 3.112

The Department of Defence ensure, for complex procurements, that there is traceability between request for tender (RFT) requirements, the risks and issues identified during the tender assessment process, and the negotiated outcomes.

Department of Defence response: *Agreed.*

Recommendation no. 7
Paragraph 4.10

The Department of Defence develop procurement-specific probity advice for complex procurements at the time that procurement planning begins and develop probity guidance for:

- complex procurements involving high levels of tenderer interaction; and
- managing engagement risks in the context of long-term strategic partnership arrangements.

Department of Defence response: *Agreed.*

Recommendation no. 8
Paragraph 4.25

The Department of Defence make appointment of external probity advisers mandatory for all complex procurements with high probity risks, such as procurements with high levels of tenderer interaction.

Department of Defence response: *Agreed.*

Summary of entity response

29. The proposed audit report was provided to Defence. Defence's summary response is reproduced below. The full response from Defence is at Appendix 1. Improvements observed by the ANAO during the course of this audit are listed in Appendix 2.

Department of Defence

Defence acknowledges the findings contained in the audit report on Defence's Management of Contracts for the Supply of Munitions, which assessed the effectiveness of the procurement and contract establishment for the Department's Strategic Domestic Munitions Manufacturing contracting arrangement.

The Mulwala and Benalla munition factories underpin Australia's ability to develop critical propellants, explosives and munitions for the Australian Defence Force and are recognised as a world-class capability. Since this procurement activity, the strategic landscape has changed, as outlined in the Defence Strategic Update of 2020 and the Defence Strategic Review in 2023. The National Defence Strategy further prioritises these factories as critical and foundational industrial capabilities for Australian domestic manufacturing, supporting sovereign resilience and our allies.

Defence welcomes collaborative engagement with our industry partners in delivering unique capability outcomes. Defence acknowledges and understands the need to ensure that such engagement is appropriately managed, and will strengthen the guidance in relation to identifying and managing procurement and probity risks early in the process as well as maintaining these records for the life of the procurement activity. Defence is continually improving and updating the Defence frameworks that underpin the issues raised.

Key messages from this audit for all Australian Government entities

30. Below is a summary of key messages, including instances of good practice, which have been identified in this audit and may be relevant for the operations of other Australian Government entities.

Procurement

- Entities can demonstrate compliant, transparent, and accountable procurement processes through the creation and retention of appropriate records, including for: decisions on the procurement approach; assessment against selection criteria; engagement with tenderers; and the rationale for proceeding to negotiations.
- Procurements involving high levels of interaction with potential tenderers require active management of engagement probity risks, including ensuring that all relevant interactions are appropriately documented and visibility is maintained over key records such as conflict of interest declarations and probity advice.
- Effective risk management during procurement processes is supported by identifying, assessing and treating procurement risks early in the process and thereafter on an ongoing basis, including developing and maintaining a risk management plan, risk registers, and mitigation strategies for all risks.

Audit findings

1. Background

Introduction

1.1 The Mulwala facility in New South Wales is the sole remaining manufacturing site of military propellants and high explosives in Australia. The nearby munitions facility at Benalla, Victoria, uses some of the output of the Mulwala facility in its operations. Both facilities are owned by the Commonwealth and operated by a third party, Australian Munitions, a wholly owned subsidiary of Thales Australia (Thales).¹¹ Thales has managed and operated the facilities since 1999.

1.2 The Australian Government announced on 29 June 2020 that the Department of Defence (Defence) had signed a new 10-year agreement valued at \$1.2 billion with Thales for the continued management and operation of the Mulwala and Benalla facilities.¹² The agreement was intended to provide surety of supply of key munitions and components for the Australian Defence Force (ADF) and maintain a domestic munitions manufacturing capability. The agreement took effect on 1 July 2020 and resulted from a complex multi-year sole source procurement begun in 2016 that had followed a terminated competitive procurement process undertaken between 2009 and 2014.

1.3 The Australian Government also announced on 29 June 2020 a new contract between the Commonwealth and NIOA Munitions for a tenancy at the Benalla munitions factory.¹³ This agreement was to establish NIOA as a tenant alongside Thales Australia and provide opportunities for domestic manufacturing while enhancing supplies of key munitions for Defence.¹⁴

Defence industry policies

1.4 The Australian Government's defence industry policies have referenced the importance of a domestic munitions manufacturing capability to support the ADF since the release of the 2009 *Defence White Paper* in May 2009.¹⁵

1.5 On 24 April 2023, the Australian Government released a public version of the final report of the *Defence Strategic Review* (DSR).¹⁶ It referenced the continuing importance of advanced munitions manufacturing, stating that the immediate focus must be on consolidating ADF guided weapons and explosive ordnance (GWEO) needs, establishing a domestic manufacturing capability, and the acceleration of foreign military and commercial sales. The report further outlined that, to do this, the ADF must hold sufficient stocks of GWEO and have the ability to manufacture certain lines, with the realisation of a GWEO enterprise being 'central to achieving this objective.'¹⁷

11 See footnote 1.

12 See footnote 2. The contract price relates to the 10-year initial contract term and does not include the cost to Defence of additional tenure able to be awarded on the basis of satisfactory contractor performance at the seven-year (three years tenure) and nine-year (two years tenure) marks.

13 See footnote 3.

14 See footnote 4.

15 Department of Defence, *Defending Australia in the Asia Pacific Century: Force 2030*, 2 May 2009, p. 128, available from <https://www.defence.gov.au/about/strategic-planning/defence-white-paper> [accessed 5 January 2024].

16 Department of Defence, *Defence Strategic Review*, 24 April 2023, available from <https://www.defence.gov.au/about/reviews-inquiries/defence-strategic-review> [accessed 11 October 2023].

17 *ibid.*, p. 68.

1.6 At June 2024, the implementation of a GWEO enterprise remains a key government priority, with the domestic manufacture of GWEO and munitions in Australia included: as one of seven ‘Sovereign Defence Industrial Priorities’ in the *Defence Industry Development Strategy* (announced in February 2024)¹⁸; and as part of the ‘immediate priorities’ set out in the public versions of the *2024 Integrated Investment Program* (IIP) and the *2024 National Defence Strategy* (both announced on 17 April 2024).¹⁹

Defence’s administrative arrangements

1.7 On 5 May 2023, the Minister for Defence Industry announced the appointment of a senior responsible officer with responsibility for a Defence GWEO enterprise.²⁰ At 19 June 2024, Defence’s website stated that the facilities at Mulwala and Benalla ‘are key assets within the GWEO enterprise and will play a role in the expansion of domestic GWEO manufacturing.’²¹

1.8 Defence’s Capability Acquisition and Sustainment Group (CASG) held primary responsibility for overseeing contractor management of the Mulwala and Benalla facilities from the time of CASG’s establishment in 2015 until May 2023, when Defence established the GWEO Group. The Chief of Joint Capabilities was designated as the Capability Manager in July 2018, as part of Defence’s implementation of the ‘One Defence’ Capability Policy Framework.²² In May 2023, the Chief of GWEO assumed the Capability Manager role.

1.9 At 7 June 2024, the GWEO Group consisted of two divisions — the GWEO Systems Division and GWEO Manufacturing Division. The Industrial Delivery Branch within the GWEO Manufacturing Division is responsible for the provision of contracted support for the operation and maintenance of the Benalla and Mulwala facilities. The contract is managed day-to-day by the Strategic Domestic Munitions Manufacturing team based in Penrith, New South Wales.

Contracting arrangements

1.10 Thales has managed and operated the facilities at Benalla and Mulwala under several different contractual arrangements since 1999 (outlined in Appendix 3). The arrangements examined as part of this audit are outlined below at paragraphs 1.11 to 1.17.

18 See: Minister for Defence Industry and International Development and the Pacific, ‘Landmark strategy to maximise support for Defence industry’, media release, 29 February 2024, available from <https://www.minister.defence.gov.au/media-releases/2024-02-29/landmark-strategy-maximise-support-defence-industry> [accessed 29 February 2024] and Department of Defence, *Defence Industry Development Strategy*, 29 February 2024, pp. 18–19, available from <https://www.defence.gov.au/about/strategic-planning/defence-industry-development-strategy> [accessed 29 February 2024].

19 See Department of Defence, *Integrated Investment Program*, 17 April 2024, pp. 15–16, available from <https://www.defence.gov.au/about/strategic-planning/2024-national-defence-strategy-2024-integrated-investment-program> [accessed 22 April 2024]; Department of Defence, *National Defence Strategy*, 17 April 2024, p. 38, available from: <https://www.defence.gov.au/about/strategic-planning/2024-national-defence-strategy-2024-integrated-investment-program> [accessed 22 April 2024].

20 See footnote 9.

21 See: <https://www.defence.gov.au/project/gweo> [accessed 4 January 2024].

22 Under Defence’s capability development framework, capability managers (usually the military Service Chiefs or Chief of Joint Capabilities) are accountable for the ‘development, introduction and sustainment of assets through the Product Life Cycle’.

Domestic Munitions Manufacturing Arrangements project (2009–14)

1.11 Defence established the Domestic Munitions Manufacturing Arrangements (DMMA) project in December 2009 to determine successor arrangements to the 1998–2015 agreements.²³ The project scope and competitive procurement methodology were approved by government in June 2012. The DMMA procurement process was suspended in January 2014 in response to a November 2013 Defence Gate Review recommendation²⁴, and pending direction from the Australian Government on the long-term future of the facilities.²⁵ The DMMA procurement process was terminated in September 2014.

2015–20 Strategic Munitions Interim Contract

1.12 In November 2014, Defence entered into the 2015–2020 Strategic Munitions Interim Contract (SMIC, or 2015 interim contract) with Thales through a sole source process. The interim contract was for a period of five years commencing on 1 July 2015.

1.13 Auditor-General Report No.26 2015–16 *Defence's Management of the Mulwala Propellant Factory* noted that there would be significant merit in another approach to market to replace the 2015 interim contract. The report included two recommendations that were agreed by Defence. Recommendation 1 was:

To achieve better value from the significant investment in a domestic munitions capability to date, by the end of 2016, Defence:

- (a) advise the Government on options for the operation and maintenance of the Mulwala and Benalla Facilities from June 2020; and
- (b) develop a plan for the timely and cost-effective implementation of the Government's preferred option.²⁶

1.14 Consistent with advice received from Defence in mid-2017, the Minister for Defence Industry announced on 6 February 2018 that Defence would enter into direct negotiations with Thales to establish a 'new strategic arrangement for the management and operation of the factories, improving price competitiveness and increasing export potential for Australian-manufactured ammunition and explosive products.'²⁷

23 Auditor-General Report No.26 2015–16 *Defence's Management of the Mulwala Propellant Facility*, paragraphs 4.19 to 4.28.

24 The review concluded that the DMMA request for tender (RFT) was not ready to be released in January 2014. The review recommended that alternative options, including reshaping of the DMMA project, be developed and provided for government consideration as a priority. The Mulwala Redevelopment Project, the purpose of which was to modernise the facilities at Mulwala, was examined in detail in Auditor-General Report No.26 2015–16 *Defence's Management of the Mulwala Propellant Factory*.

25 See Auditor-General Report No.26 2015–16 *Defence's Management of the Mulwala Propellant Facility*, paragraphs 4.19 to 4.28.

26 *ibid.*, paragraphs 4.19 to 4.28. The second ANAO recommendation was:

To plan effectively for the decontamination and demolition of redundant buildings at the Mulwala Facility, the ANAO recommends that Defence:

- (a) develop a risk-based implementation plan for management of the site; and
- (b) advise the Government on relevant risks and costs by mid-2016.

27 K Ziesing, 'The future of Benalla and Mulwala', *Australian Defence Magazine*, 16 February 2018, available from <https://www.australiandefence.com.au/budget-policy/the-future-of-benalla-and-mulwala> [accessed 14 June 2023].

2020–30 Strategic Domestic Munitions Manufacturing contract

1.15 The new strategic arrangement involved a sole source procurement and was implemented through the SDMM contract which took effect on 1 July 2020. A timeline of the procurement process is set out in Appendix 4.

1.16 The SDMM contract is comprised of leases between Defence and Thales for all of the Mulwala facility, part of the Benalla facility, certain surrounding pastoral lands, and an agreement to provide services and supplies (see Table 1.1 below).²⁸ At June 2024, there were 54 types of munitions listed within the contract that are able to be supplied to Defence.

1.17 A point of difference from the previous contractual arrangements is Thales' role as the Commonwealth's 'strategic partner' under the SDMM contract. Thales is required to 'share information in a transparent manner about future Contractor investment opportunities under consideration at the Facilities [Mulwala and Benalla]' and 'work collaboratively with the Commonwealth to enable investment opportunities to align with Best for Defence, the Contract Objectives and to provide mutual benefits to the Parties.'

Value of SDMM contract

1.18 At 19 June 2024, the SDMM contract had a reported value of \$1,369 million (GST inclusive) on Austender. This was an increase of \$108 million (8.5 per cent), due to the inclusion of survey and quote work orders, compared to the original reported value of \$1,261 million (GST inclusive).²⁹

1.19 Key components of the SDMM contract price as set out in the contract — which were GST exclusive figures — at 31 March 2024, are outlined in Table 1.1.

Table 1.1: Components of the SDMM contract price at 31 March 2024

Price component	Total component price (GST exclusive) (\$AUD millions) ^d
Facilities operations payment ^a	913.8
Minimum order value ^b	225.0
Survey and quote ^c	103.9
Total	1242.7

Note a: The facilities operations payment includes the facilities operating cost, utilities pass through costs, facilities operating payment contingency, general and administrative costs, Thales corporate fee, and Thales' profit margin. At contract signature, Thales and Defence agreed the facilities operation payment for the first two years of the contract, with the remaining eight years of the initial 10-year term estimated by escalating the agreed amount. The facilities operations payment component of the contract price has decreased from \$921.4 million as a result of a periodic cost review undertaken between October 2021 and May 2022. These reviews set the price at regular intervals during the contract term, taking escalation and cost efficiencies into account.

28 Specifically, Thales provides the following services: management of services; asset and maintenance management, engineering, and munitions and supplies services; provision and support of support resources including personnel, technical data, packaging, and computer support; verification and validation; quality management; health, safety and environmental management; and implementation of a 'Continuous Improvement and Efficiencies Program'.

29 The original value reported on AusTender was \$1,261,027,000 (GST inclusive). See <https://www.tenders.gov.au> [accessed 20 February 2024]. AusTender amendments related to survey and quote work orders (see paragraph 1.20).

Note b: The minimum order value reflects the agreed minimum order value of \$25 million per year for Years 1–5 and \$20 million per year for Years 6–10. Accordingly, it does not include the value of munitions orders placed by Defence in excess of the minimum order value.

Note c: The survey and quote value reflects all price-impacting survey and quote work orders, excluding those related to munitions orders, approved by Defence at 31 March 2024.

Note d: The original total contract price was \$1,146,388,000 million (GST exclusive).

Source: ANAO analysis of Defence documentation.

1.20 In addition to the facilities operation payment and munitions orders (outlined in Table 1.1), Thales receives payments for undertaking other work approved by Defence under five survey and quote provisions in the contract. These provisions are covered by a separate pricing structure. The five categories of survey and quote provisions are: munitions supply services; capital works services; research and development services; pass-through cost services; and miscellaneous services.

Funding arrangements and expenditure against the SDMM contract

1.21 The facilities operations payment is funded under Product Delivery Schedule CJC01/Integrated Product Management Plan GWEO01 (CJC01/GWEO01), with survey and quote services being funded from various funding sources.³⁰ Munitions supply survey and quote services are funded through the individual military Services' (Army, Navy or Air Force) sustainment or acquisition budgets, while all other survey and quote services are predominately funded under CJC01/GWEO01 and acquisition budgets.

1.22 CJC01/GWEO01 actual expenditure from 1 July 2020 to 31 December 2023 was \$469.6 million, with:

- \$399.7 million spent on the SDMM contract at 31 December 2023; and
- \$69.9 million spent on activities related to multi-tenancy, facility maintenance, major works and 'engineering & branch support'.

1.23 Allocated funding to 30 June 2030, and actual expenditure at 31 December 2023, under CJC01/GWEO01 on the SDMM contract and associated capability costs are outlined in Table 1.2.

30 Sustainment arrangements in Defence are governed by Materiel Sustainment Agreements (MSAs), which consist of two levels.

- The first level is the heads of agreement. This is an overarching document that covers a series of Product Delivery Schedules. The heads of agreement contains the high-level framework establishing the partnership between each Capability Manager and area of Defence responsible for delivery of the capabilities for which the Capability Manager is responsible.
- The second level is comprised of Product Delivery Schedules or Integrated Product Management Plans. Each schedule or plan deals with the sustainment of a specific platform, commodity or service for the relevant Defence Service or Group. The Product Delivery Schedule defines: the supplies and services that will be provided by the delivery area; the budget that is provided by the Capability Manager; and standards for matters such as responsiveness, availability levels, and maintenance timeframes.

Table 1.2: Allocated funding and actual expenditure — 1 July 2020 to 31 December 2023

Funding source	Allocated funding to 30 June 2030 (at 31 December 2023) (\$AUD)	Expenditure at 31 December 2023 (\$AUD)	Percentage of funding expended (%)
CJC01/GWEO01	1,013,527,000	469,603,028	46.3
CA59: Explosive Ordnance — Army Munitions Branch ^a	198,000,000	130,430,719	66.8
JP2092 Phase 1 GWEO Enterprise	184,900,000	14,286,733	0.1
CAF33 — Air Force Guided Weapons ^b	38,500,000	11,557,054	30.0
AIR 6000 Phase 3 ^c	11,000,000	11,742,929	106.8
Total	1,445,927,000	637,620,463	44.1

Note a: 'CA' here stands for Chief of Army, as the Capability Manager for this Army sustainment product.

Note b: 'CAF' here stands for Chief of Air Force, as the Capability Manager for this Air Force sustainment product.

Note c: AIR 6000 Phase 3 is a Defence project to acquire new weapons and countermeasures for the F-35A Joint Strike Fighters and F/A-18F Super Hornets in service with the Royal Australian Air Force.

Source: ANAO analysis of Defence documentation.

Previous Auditor-General reports

1.24 Aspects of Defence's management of the Mulwala and Benalla facilities were examined by the ANAO in the following performance audits.

- Auditor-General Report No.40 2005–06 *Procurement of Explosive Ordnance for the Australian Defence Force (Army)*.
- Auditor-General Report No.24 2009–10 *Procurement of Explosive Ordnance for the Australian Defence Force*.
- Auditor-General Report No.26 2015–16 *Defence's Management of the Mulwala Propellant Factory*.

Rationale for undertaking the audit

1.25 To establish the arrangements for the operation and maintenance of the Mulwala and Benalla facilities beyond June 2020, Defence undertook a complex and lengthy procurement process that was based on a sole source approach. This audit examined whether this process was effective and in accordance with the Commonwealth Procurement Rules.

1.26 This audit builds on previous work by the ANAO which has examined Defence's management of the Benalla and Mulwala facilities over time, and provides independent assurance to the Parliament on Defence's establishment of the arrangements for the operation and maintenance of the Mulwala and Benalla facilities beyond June 2020.

Audit approach

Audit objective, criteria and scope

1.27 The audit objective was to assess whether the arrangements for the operation and maintenance of the Mulwala and Benalla facilities from July 2020 were established through appropriate processes and in accordance with the Commonwealth Procurement Rules.

1.28 To form a conclusion against the audit objective, the following high-level criteria were selected:

- Did Defence plan effectively for the operation and maintenance of the facilities beyond the expiry of the 2015–20 interim contract?
- Did Defence conduct an effective sole source procurement process to establish the 2020–30 contractual arrangements?
- Did Defence effectively manage probity throughout the process?

1.29 This report is the first of two performance audit reports examining Defence’s establishment and management of the facilities beyond June 2020. It focuses on Defence’s establishment of the 2020–30 operating arrangements, including the tender assessment process, advice to decision makers and the decision to conduct a sole source procurement. Defence’s management of performance against the contract is the focus of a second report, which will be presented for tabling later in 2024.

Audit methodology

1.30 The audit procedures included:

- reviewing Defence records, including procurement planning, tender assessments, advice to decision-makers, and contract management documentation;
- meetings with Defence officials and Defence contractors; and
- walkthroughs of Defence systems.

1.31 The audit was conducted in accordance with ANAO Auditing Standards at a cost to the ANAO of approximately \$497,453.

1.32 The team members for this audit were James Woodward, Adam Reddiex, Jay Banpel, Jude Lynch, Raveen Spindary, and Amy Willmott.

2. Planning during the interim contract period

Areas examined

This chapter examines whether the Department of Defence (Defence) planned effectively for the operation and maintenance of the Benalla and Mulwala facilities beyond the expiry of the 2015–2020 interim contract.

Conclusion

Defence's planning processes prior to the expiry of the 2015 interim contract were partly effective. While options for the management of the facilities beyond June 2020 were developed, deficiencies were identified in Defence's subsequent procurement and probity planning processes and its advice to decision-makers.

Defence's decision to conduct a sole sourced procurement was not informed by an estimated value of the procurement prior to this decision and Defence did not document the legal basis for selecting a sole sourced procurement approach, as required by the *Commonwealth Procurement Rules* (CPRs). Probity risks were realised in 2016 when Defence personnel provided Thales with confidential information relating to its Investment Committee (IC) proposal, and advice to decision-makers did not address how value for money would be achieved and commercial leverage maintained in the context of a sole source procurement.

Areas for improvement

The ANAO made three recommendations aimed at improving Defence's procurement planning and advice to decision-makers.

2.1 The *Commonwealth Procurement Rules* (CPRs) state that procurement begins when a need has been identified and a decision has been made on the procurement requirement.³¹ Procurement continues through the processes of risk assessment, seeking and evaluating alternative solutions, and the awarding and reporting of a contract.

Were options for the management of the facilities beyond June 2020 appropriately developed and considered?

Defence provided advice to the Minister for Defence during 2014 on a range of options for the management of the facilities beyond June 2020, including: continuing with the status quo; the Commonwealth operating the facilities; and closing the facilities. These options continued to be considered by Defence and the government between 2015 and mid-2017. In 2016, a clear preference emerged to sole source the operation and maintenance of the facilities to the incumbent, Thales. By July 2016, Defence was primarily focused on developing a proposed 'strategic partnership' arrangement with Thales. Defence did not document the legal basis (that is, an exemption provided by paragraph 2.6 of the *Commonwealth Procurement Rules*) for the proposed sole source activity to inform its subsequent procurement planning.

31 The CPRs are a legislative instrument issued by the Minister for Finance under subsection 105N(1) of the *Public Governance, Performance and Accountability Act 2013*. Officials from non-corporate Commonwealth entities (including Defence) must comply with the CPRs when performing duties related to procurement. The CPRs are updated from time to time and the relevant version is identified as necessary in this chapter.

A procurement-specific probity framework was not put in place until July 2018, to help manage probity risks in the context of pursuing a partnership arrangement with Thales. Probity risks crystallised during 2016 when:

- senior Defence personnel advised Thales at an October 2016 summit meeting that Defence's preference would be to progress a government-owned contractor-operated arrangement with Thales into the future.
- a Defence official sought assistance from and provided information to Thales in November 2016 on the development of internal advice to the IC, Defence's committee processes, and internal Defence thinking and positioning. Government information of this sort is normally considered confidential, and the relevant email exchange evidenced unethical conduct.

Domestic Munitions Manufacturing Arrangements project

2.2 From July 1998 to June 2015, the production of propellant and high explosives at the Mulwala facility, and the production and sale of munitions from the Benalla facility, were governed by the Mulwala Agreement and the Strategic Agreement for Munitions Supply (SAMS). Defence undertook extensive work as part of its Domestic Munitions Manufacturing Arrangements (DMMA) Project between 2009 and 2014 to determine successor arrangements to the 1998–2015 agreements (see Appendix 3).³²

2.3 After suspending the DMMA procurement process in January 2014, Defence entered into the 2015–2020 Strategic Munitions Interim Contract (SMIC, or 2015 interim contract) with Thales through a sole source process in November 2014. The interim contract was for five years commencing on 1 July 2015.

2.4 The DMMA project work included commissioning two studies in 2011–12 to examine the global munitions market (undertaken by the RAND Corporation) and the regional economic contribution of the Benalla and Mulwala facilities (undertaken by KPMG).³³ These studies informed Defence's approach in establishing the new 10-year Strategic Domestic Munitions Manufacturing (SDMM) arrangements from July 2020 and were drawn on in Defence advice to responsible ministers for several years thereafter. The RAND Corporation study (RAND review) observed the following.

- 'If maintaining a domestic munitions industry is desirable, using the full production capacity at Benalla is the key to controlling costs'.
- 'Increased production at Benalla would lower the overall cost per unit of munitions output as subsidised labour is shifted to production and production costs decrease due to efficiencies tied to volume'.

32 Auditor-General Report No.26 2015–16 *Defence's Management of the Mulwala Propellant Facility*, paragraphs 4.1 to 4.28.

33 *ibid.*, paragraphs 4.14 and 4.21. The studies concluded that there was likely to be significant ongoing global munitions demand, and that regional economic benefits were extensive. Defence subsequently noted a likely requirement for considerable ongoing government assistance for the operator of the sites due predominately to a large reduction in global and domestic munitions demand.

- 'By aligning investment with ADF demand, the CoA [Commonwealth of Australia] can increase production at Benalla and Mulwala (which would increase sales at Benalla), minimising the size of the subsidised labour pool.'³⁴

2.5 The DMMA procurement methodology was approved by government in June 2012. The procurement was to involve a two-stage process comprising a request for proposal (RFP) process followed by a request for tender (RFT) process. The RFP was issued to six companies on 28 November 2012 and closed on 25 March 2013.³⁵

2.6 Evaluations of the RFP responses were finalised on 19 July 2013, with three respondents recommended to proceed to the RFT stage. Of those three, Thales was the third-ranked respondent. Defence's evaluation found that on a number of parameters, Thales' proposal was not as competitive as the other shortlisted respondents. Defence's evaluation records stated that Thales' proposal involved 'significantly higher risk to the Commonwealth' and required significantly more capital investment than the two other proposals (indicating a 'significant reliance on ongoing Commonwealth support').

DMMA suspension and the 2015 interim contract arrangements

2.7 The DMMA RFT was not released in December 2013 as planned and the process was suspended in January 2014, in response to a November 2013 Defence Gate Review recommendation and decisions by the Australian Government on the long-term future of the facilities. The Gate Review had concluded that the DMMA RFT was not ready to be released and recommended that alternative options, including reshaping of the DMMA project, be developed and provided for government consideration as a priority.³⁶

2.8 In March 2014, the DMMA Project Director issued a probity guidance note to the DMMA project team, which outlined that the delays to the project had required interim arrangements to be established with Thales 'in order to deal with the potential gap between the end of the current arrangements (30 June 2015) and the commencement of the new arrangement'. The guidance note further stated that '[s]ome personnel who have been involved in conducting the DMMA process will be assisting in these additional activities.' The guidance note contained two attachments. The first, titled 'Responsibility Areas', set out the probity principles for the 'additional activities'. The second, titled 'Other Matters to be Conscious of (Specifically for Individuals Engaging with Thales)', included the following 'matters' (and related guidance).

34 See Auditor-General Report No.26 2015–16 *Defence's Management of the Mulwala Propellant Facility*, paragraphs 4.14 and 4.21.

35 The procurement approach approved by government in June 2012 was to include a 'worldwide' invitation to register (ITR) process, followed by an RFT released to shortlisted respondents. The ITR was released in March 2011, with six consortia down-selected to respond to an RFT in November 2011. During the down-select process, Defence refined the procurement approach following a Defence Gate Review in October 2012, which had recommended that the DMMA project adopt a two-stage approach comprising both RFP and RFT processes.

36 Defence suspended release of the DMMA RFT due predominately to the expected high tendering risk and associated cost driven by uncertainty in the schedule and eventual capability of the facilities being delivered under the Mulwala Redevelopment Project. The Mulwala Redevelopment Project, the purpose of which was to modernise the facilities at Mulwala, was examined in detail in Auditor-General Report No.26 2015–16 *Defence's Management of the Mulwala Propellant Factory*, paragraphs 4.19 to 4.28. Many elements of the DMMA business case approved by government in June 2012 were also considered by Defence to be no longer valid, with business models outlined response to the RFP possibly inconsistent with government expectations.

- ‘Ensure the continued provision of a level playing field to all tenderers’.³⁷
- ‘Ensure that interactions with Thales in the course of dealing with these matters are appropriate and consistent with a resumption of the DMMA RFT’.³⁸
- ‘Enable Defence to release (to the fullest extent possible, but subject to appropriate confidentiality obligations to Thales) updated information from Thales in respect of the facilities and their condition to other tenderers’.
- ‘Avoid vendor lock in’.³⁹

2.9 Between January and August 2014, Defence continued to provide advice to government, including seeking direction from the Minister for Defence regarding the future of the facilities.⁴⁰ Defence’s advice examined future options and cost estimates for the sites, which were: close and potentially sell the facilities; recommence the DMMA process; or establish a direct source medium term performance-based arrangement for operation of the facilities, most likely with Thales.

2.10 At a meeting on 25 June 2014, the minister requested that Defence prepare a further submission to inform government, notionally in late 2014, regarding the long-term future of domestic munitions manufacture. The minister also requested that a submission detailing interim arrangements for the short-term operation of the facilities be prepared for the minister’s consideration.⁴¹

2.11 On 28 August 2014, Defence advised the minister that it expected to enter into the interim arrangements in October 2014, pending successful negotiations with Thales, and that it intended to bring forward a submission for government consideration by the end of 2014 for a decision on the long-term arrangements for the facilities. Defence advised the minister that a decision any later than 30 June 2017 on the long-term arrangements would pose ‘considerable schedule challenges’ for the conduct of another competitive tender process or disposal of the facilities as a ‘going concern’ by June 2020.

2.12 On 1 September 2014, the minister wrote to the Prime Minister advising that the DMMA process had been suspended in January 2014 and ‘a business case around the most appropriate mechanisms to manage ADF munitions purchase’ would be brought forward for government consideration in 2016. The minister’s letter stated there were three broad options for the future of the sites — closing the sites and acquiring ADF munitions on the global market, recommencing the suspended DMMA process, or a direct source medium term arrangement with Thales.⁴²

37 The document directed Defence personnel to maintain records of information provided to Thales or received from Thales during the interim contract negotiations and consider whether it should be disclosed to other DMMA tenderers ‘so as to give those other tenderers a “level playing field” to compete for future DMMA contracts.’

38 The document noted that this was ‘to avoid a situation where other tenderers consider that they will not be able to compete because Defence is too close to Thales’ and advised Defence personnel to be ‘aware of **perception risks** for the DMMA process (if resumed) [emphasis in original].’

39 The document directed Defence personnel to ‘[c]onsider whether **proposed positions or clauses** may produce an outcome which means that other tenderers will not be interested or competitive in tendering for DMMA, should the RFT process be resumed [emphasis in original].’

40 Defence’s April 2014 advice to the minister was discussed in Auditor-General Report No.26 2015–2016 *Defence’s Management of the Mulwala Propellant Facility*, at paragraph 4.25.

41 *ibid.*, paragraph 4.26.

42 Neither Defence nor the Department of Prime Minister and Cabinet could identify within their respective records whether the Prime Minister had responded to the minister’s 1 September 2014 letter.

2.13 On 8 September 2014, the minister noted Defence's advice of 28 August 2014 and approved 'Defence entering into interim arrangements for ongoing operation of the Benalla and Mulwala facilities with the incumbent contractor, Thales Australia, for a period of up to 5 years'. There is no evidence that a business case was brought forward in 2016 for the government's consideration, as advised in the minister's 1 September 2014 letter to the Prime Minister nor were the facilities brought forward for any further government consideration between 2016 and July 2020 (when the current SDMM arrangements commenced).

Advice on long-term arrangements for the facilities

2.14 Under the interim arrangements executed in November 2014, Defence was obligated to give Thales written notice on or before 30 June 2017 of any extension to the 2015 interim contract beyond 30 June 2020. Defence's advice on the long-term arrangements was not progressed until February 2016, after receiving a request for advice from the Minister for Defence.⁴³

2.15 In response to the minister, Defence advised on 19 February 2016 that it would be in a position to 'provide advice to Government in mid-2017 on options for the future operation of the two factories'. To inform the development of that advice, Defence noted that it intended to 'conduct an analysis of the future strategic requirement for the facilities, taking into account recommendations from the 2016 Defence White Paper in relation to domestic manufacturing capabilities'.⁴⁴

2.16 Defence considered options for the long-term operation of the facilities between March and October 2016. This was consistent with the approach developed by Defence to implement the ANAO recommendations agreed in February 2016 (see paragraph 1.13), which included reviewing the commercial data from the terminated DMMA process and developing a paper for the IC.⁴⁵ Defence's planned approach also included advice to government on options to be investigated, followed by further advice outlining Defence's findings and recommendations.⁴⁶

2.17 Defence records state that the ANAO recommendations were 'completed' in June 2017. As discussed at paragraph 2.13, a submission on the long-term operation of the facilities was not brought forward for consideration by the government between September 2014 and July 2020.

Munitions Manufacturing Integrated Product Team

2.18 In January 2015, Defence established a Munitions Manufacturing Integrated Product Team (IPT) to facilitate collaboration between the Capability Acquisition and Sustainment Group (CASG), Joint Logistics Command (JLC), the ADF Services and Thales 'for execution of the Government's

43 On 11 February 2016, the minister asked Defence to advise on when it would be in a position to provide advice on options for the long-term future of the facilities.

44 The *2016 Defence White paper* and the accompanying *2016 Integrated Investment Program* and *2016 Defence Industry Policy Statement* were released on 25 February 2016. See: Minister for Defence, 'Launch of the 2016 Defence White Paper', media release, 25 February 2016, available from <https://www.minister.defence.gov.au/speeches/2016-02-25/minister-defence-launch-2016-defence-white-paper> [accessed 10 January 2024]. For convenience, this report refers to all three documents as the *2016 Defence White Paper*.

45 The committee at this time was called the Defence Capability and Investment Committee. It is now called the Defence Investment Committee. For convenience, Investment Committee is used for both in this report.

46 Those investigations were to include: developing a Project Management Plan, including an acquisition strategy, contracting methodology and risk assessment; and developing an industry consultation paper on options.

directive for the domestic munitions manufacturing' at the facilities.⁴⁷ The IPT was to be an advisory body for ADF Capability Managers and a forum for discussion and prioritisation of domestic munitions manufacturing.⁴⁸

2.19 Consistent with the findings of the RAND review (see paragraph 2.4), the focus of meetings for the first two years was on increasing the use of the facilities by identifying 'potential candidate munitions for manufacture' by Thales during the interim contract period. In October 2017, the IPT was expanded to include other companies — NIOA Nominees Pty Ltd (NIOA) and Chemring Australia Pty Ltd — as a source of advice to government on the 'domestic capabilities of the industrial base'.⁴⁹ The IPT meetings occurred quarterly on average, until it was replaced in June 2018 by the Explosive Ordnance Manufacturing Review Board.

Development of advice for the Defence Investment Committee

2.20 A gate review of the Mulwala Redevelopment Project conducted in April 2016 found that it was 'not clear that the necessary underpinning work' was underway to support advice to government on long term options for the facilities. The reviewers recommended 'further work be undertaken on contractual options' for the long term operation of Mulwala to support this advice and address the ANAO recommendation.' The recommendations were agreed to by Head Joint Systems, CASG (SES Band 2 or two-star equivalent) on 19 April 2016.

2.21 Between early June and August 2016, an issues paper was developed by the Explosive Materiel Branch for consideration by Head Joint Systems. A proposed 'strategy for the future management of ... [the] factories' was set out in the issues paper and 'endorsement of the intended course of action' proposed by the Explosive Materiel Branch was sought. The paper referenced learnings from the DMMA process and the Mulwala Redevelopment Project and stated that Defence's options were:

- disposal of the factories by abandonment;
- a government-owned government-operated (GOGO) model;
- a government-owned contractor-operated (GOCO) model; and
- a contractor-owned contracted-operated (COCO) model.

2.22 The paper also stated that an 'assessment of risks' would support 'selecting either the GOCO or COCO option without the need to approach the market'. The risks identified focused on technical, schedule, commercial and financial risks associated with a change of operator, with Defence considering a new arrangement with Thales the lowest risk option for government.

47 JLC was part of Defence's Vice Chief of the Defence Force Group when the IPT was established but became part of the Joint Capabilities Group (JCG) when JCG was established in July 2017.

48 The IPT was held in coordination with a Munitions Supply IPT, which was a Defence-only meeting held to discuss options and consider priorities prior to each Munitions Manufacturing IPT meeting.

49 NIOA's unsolicited proposal, which is discussed from paragraphs 3.16–3.27, was presented to the IPT by NIOA at its 17 October 2017 meeting. NIOA's proposal envisaged an expanded presence at Benalla to support assembly and manufacture of other munitions.

2.23 The recommendations in the issues paper included the following.

- Do not go to market as the market is well understood and the DMMA process provided sufficient information to support decision-making.⁵⁰
- Retain a GOCO model as the lowest risk option to mitigate immediate environmental clean-up costs and avoid the need to gain/hold a Major Hazard Facility licence.
- Retain Thales as operator of the two sites, as it is a known entity with an existing performance-based contract and experience to operate a Major Hazard Facility.
- Extend commercial SMIC (2015 interim contract) arrangements as they allow for the supply of ammunition to be split from operation of the factories.
- Institute new governance arrangements better suited to strategic management of the factories as a capability, rather than a contract to supply ammunition. In particular, the paper stated that ‘future ownership arrangements should establish a long term strategic partnership between Defence and the operator’ and should ‘emphasise the benefit of mutual respect and cooperation.’

2.24 On 12 July 2016 Head Joint Systems endorsed a sole source procurement approach with Thales and approved further development of this approach for consideration by the IC. Between 12 and 18 July 2016, officials within the Explosive Materiel Branch of CASG’s Joint Systems Division raised the following issues regarding the proposed sole source approach.

- The potential merit in opening the facilities to global suppliers who could leverage their global business to achieve maximum economies of scale and offset low ADF demand.
- That by deciding to sole source to Thales at this stage, Defence had ‘discounted the potential benefits of another operator with a larger munitions business, without truly testing the Course of Action’.
- Insufficient consideration of insights from the cancelled DMMA process.
- That Defence had a better understanding of the facilities to compare operator options that it did not have pre-2015.⁵¹

2.25 On 18 July 2016, the Director-General Explosive Materiel (SES Band 1 or one-star equivalent) acknowledged this input, noting however that the endorsed approach was ‘consistent with where the DEPSEC CASG [Deputy Secretary CASG] would want ... to take things’ and that ‘it would be high risk (potentially disastrous to go to another operator).’⁵²

50 The paper stated that the DMMA process had established that: ‘all potential contractors to operate the factories would require ongoing government subsidies to remain competitive in the world market’; ‘the transition from manufacturing “Thales proprietary” products in both factories ... to manufacturing, qualifying and certifying the new contractor’s products involved no less than a two year transition period, with risk being borne by the Commonwealth’; there was ‘no expertise in Australia in relation to operation/maintenance of the factories as Major Hazard Facilities other than Thales’; and ‘to maximise the strategic benefit of the factories, Benalla had to be working at maximum capacity.’

51 These officials were directors (EL2 level) within the branch with responsibilities directly related to the facilities, including chairing the Munitions Manufacturing Integrated Product Team, and previous key roles for the DMMA project such as leading parts of the RFP evaluation and chairing the 2015 interim contract RFT evaluation.

52 The Deputy Secretary CASG was updated on progress on 29 July 2016 by Head Joint Systems and the Director-General Explosive Materiel.

Procurement framework matters

2.26 Two documents (a draft Project Execution Strategy and Preliminary Procurement Strategy) were progressively developed between July 2016 and September 2017, in line with the approach endorsed by Head Joint Systems (see paragraph 2.24). The legal basis for the proposed sole source procurement approach was not documented at the time, and this did not occur until August 2018.⁵³

2.27 The *Commonwealth Procurement Rules 2014* (CPRs) applied at the time of the sole source procurement decision.⁵⁴ Under the CPRs, a sole source procurement above the relevant threshold could be undertaken by relying on the following provisions.

- Paragraph 2.6, which provided that:
Nothing in any part of these CPRs prevents an official from applying measures determined by their Accountable Authority to be necessary for the maintenance or restoration of international peace and security, to protect human health, for the protection of essential security interests, or to protect national treasures of artistic, historic or archaeological value.
- Appendix A, which listed 17 exemptions from the rules in Division 2 of the CPRs regarding competitive processes. Exempt procurements were still required to be undertaken in accordance with value for money requirements.

2.28 These CPR provisions were reflected in the Defence Procurement Policy Manual (DPPM) applying at the time, which stated that the Secretary of Defence had determined, for paragraph 2.6 of the CPRs, that the procurement of goods under Federal Supply Code 13 Ammunition and Explosives and services relating to operation of government-owned facilities was exempt from the operation of Division 2 of the CPRs. Defence subsequently relied on this part of the DPPM to support its decision to exempt the procurement from Division 2 of the CPRs and undertake a sole source procurement.

2.29 The DPPM also stated that ‘if a procurement is exempt from Division 2 of the CPRs, Defence officials are still required to undertake their procurement in accordance with Division 1 of the CPRs.’⁵⁵ The DPPM further stated that:

where a determination is made that an exemption is available, the officer responsible for signing the Endorsement to Proceed [EtP] must ensure that the reasons supporting that determination are documented and appropriately captured.⁵⁶

53 The *Commonwealth Procurement Rules* (CPRs) are issued by the Finance Minister under subsection 105B(1) of the *Public Governance, Performance and Accountability Act 2013* (PGPA Act), and form the core of the Commonwealth procurement framework. They provide the basic compliance framework for regulated Commonwealth entities in undertaking procurements. As a legislative instrument the CPRs have the force of law. Defence relied on an exemption provided by paragraph 2.6 of the 2014 CPRs to conduct a sole source process rather than an open tender process for a procurement above the relevant threshold.

54 The CPRs are a legislative instrument and are updated from time to time. The 2014 CPRs applied from July 2014 to February 2017. See: [https://www.legislation.gov.au/search/text\(%22commonwealth%20procurement%20rules%22,nameandtext,contains\)/status\(notinforce\)/pointintime\(latest\)/collection\(legislativeinstrument\)](https://www.legislation.gov.au/search/text(%22commonwealth%20procurement%20rules%22,nameandtext,contains)/status(notinforce)/pointintime(latest)/collection(legislativeinstrument))

55 Division 1 of the CPRs sets out the rules for all procurements, including the requirement that ‘Officials responsible for a *procurement* **must** be satisfied, after reasonable enquires, that the *procurement* achieves a value for money outcome’ (CPRs, paragraph 4.4) [emphasis in original].

56 The circumstances in which an Endorsement to Proceed (EtP) is required for Defence procurements are discussed in paragraph 3.28. As discussed in paragraph 3.28, an EtP was required for this procurement.

2.30 Defence documented its reliance on paragraph 2.6 of the CPRs in an EtP signed in August 2018 (see paragraph 3.28), two years after the July 2016 agreement by Head Joint Systems for a sole source procurement approach with Thales. The legal basis for Defence's preferred sole source approach (that is, its reliance on paragraph 2.6 of the CPRs) was therefore not documented as part of the 2016 decision-making process on the procurement method.

Recommendation no. 1

2.31 The Department of Defence document at the time the proposed procurement activities are decided:

- the circumstances and conditions justifying the proposed sole source approach, to inform subsequent procurement planning; and
- which exemption in the CPRs is being relied upon as the basis for the approach and how the procurement would represent value for money in the circumstances.

Department of Defence response: *Agreed.*

2.32 *Defence notes that its current Defence Commercial Framework requires officials to document the commercial basis for proposed sole source procurement activities.*

2.33 *Defence is reviewing the One Defence Capability System (ODCS). This review will ensure that ODCS is reflective of all relevant procurement policy considerations including sufficiently documenting for procurement planning.*

2.34 A draft Project Execution Strategy (PES) for the future ownership of Benalla and Mulwala was developed, which sought to retain the factories under commercial management by Thales either under a five-year extension of the 2015 interim contract or a renegotiated version of the interim contract, under which Defence would commit to a strategic partnership with Thales and new governance arrangements.⁵⁷ Under either approach, Defence would commit to a strategic partnership with Thales and new governance arrangements.

2.35 Since April 2017, the DPPM has required the development of a written procurement plan, which 'explains how the procurement is to be undertaken', for all procurements valued at or above \$200,000 (GST inclusive).⁵⁸ While not a requirement at the time⁵⁹, a draft Preliminary Procurement Strategy for a Future Domestic Munitions Manufacturing (FDMM) activity was developed for the IC's consideration in December 2016.⁶⁰

57 Using the approved template, a PES was progressively developed (but not finalised) by the Explosive Materiel Branch between October 2016 and September 2017 (see footnote 95). A PES is a template introduced under Defence's Smart Buyer Decision-Making Framework in October 2016. An initial design paper for the framework had been released in Defence as an exposure draft on 5 May 2016.

58 The DPPM drew a distinction between the business case, which 'explains why a procurement is being undertaken, including its value proposition', and the procurement plan.

59 Prior to April 2017, the requirement only applied to 'Major Capital Equipment' procurements. The DPPM defined 'Major Capital Equipment' as a 'capital equipment project of \$20 million or more, or of less than \$20 million but with individual items of \$1 million or more, or equipment projects of less than \$20 million but with strategic significance.

60 Defence did not retain a record of the approval of the document by the Director-General Explosive Material and the Head Joint Systems. The document noted that their approval was required.

2.36 The draft strategy document proposed progressing an options paper for government consideration as a ministerial submission (rather than a cabinet submission), with the draft to be considered by the IC and Defence Committee by mid-November 2016 and advice provided to the minister in December 2016.⁶¹ This approach anticipated receiving government direction in February 2017 and approval of contractual arrangements by Quarter 2 of 2019.

2.37 The draft strategy document also observed that allowing the interim contract to expire would challenge the value for money of Defence's investment to date and Defence would be liable for the cost of decommissioning activities. The document also noted that extending Thales as the incumbent operator would not encourage competition in line with the value for money requirements of the CPRs. Rather, it was noted that Thales would be provided with significant negotiation leverage during contractual renegotiations, future munitions sales and future capital investment opportunities.

Engagement with Thales

2.38 Defence needed to engage with Thales, the current operator, on a business-as-usual (BAU) basis regarding the ongoing operation of the facilities. It was also necessary for Defence personnel to differentiate these BAU matters from procurement planning activities, so as to maintain probity in procurement and support the achievement of value for money.

2.39 Paragraph 6.6 of the 2014 CPRs stated that officials undertaking procurement must act ethically throughout the procurement, and that ethical behaviour includes 'dealing with *potential suppliers, tenderers and suppliers* equitably' (emphasis in original).

2.40 The July 2013 exposure draft of 'Defence's Industry Engagement during the Early Stages of Capability Development Better Practice Guide' (BPG)⁶² observed that:

Defence's engagement with industry can, if not planned and managed appropriately, involve or give rise to 'probity' concerns that risk damaging Defence's reputation, the quality of Defence and Government decision making and Defence's ability to achieve best value for money capability solutions. During the early stages of capability development (ie prior to First Pass Approval) these concerns may involve allegations of bias in favour of particular solutions or suppliers and / or risks to the competitiveness or fairness of future Defence procurement processes.

Whenever interacting with industry, Defence personnel should refrain from making verbal or written representations that could be perceived as binding or committing Defence or Government to a particular option or course of action that has not been officially endorsed or approved.⁶³

2.41 The BPG also noted the importance of detailed planning for industry engagement to ensure that 'all relevant probity considerations [and] risks are understood and appropriately managed'.

2.42 In early 2016, as part of its BAU activities, Defence was engaging with Thales at established governance committees, including the: Explosive Ordnance Strategic Governance Board

61 This recommendation was based on the 'available timeframe for enacting the longest lead-time procurement option' and the 'high level procurement timeline'.

62 The exposure draft was the extant version of the guide during 2016. The guide was finalised and released on 16 May 2018. The finalised guide and subsequent revisions made similar observations and noted that 'Defence personnel need to carefully plan and manage early industry engagement to avoid, or at least minimise, probity concerns.'

63 ANAO note: this was one of ten 'guiding "probity" principles' outlined in the exposure draft. It was removed prior to the document being finalised.

(EOSGB) — a discussion forum for strategic level issues established under the 2015 interim contract, which was co-chaired by Defence's Director-General Explosive Ordnance and Thales' Managing Director of Australian Munitions; and the Munitions Manufacturing Integrated Product Team — on munitions to be manufactured during the interim contract term (discussed at paragraphs 2.18 to 2.19).

2.43 Between March and April 2016, Thales and Defence senior leaders agreed that an 'Ordnance Summit' between Defence and Thales be held. Thales proposed that the summit be for senior-level discussion of topics similar to those discussed at the Munitions Manufacturing Integrated Product Team meetings, including: current operations of ordnance manufacture; future orders of munitions for Australia; and joint long-term strategic goals of ordnance manufacture in Australia.

2.44 Thales developed a presentation to support discussions at the summit meeting. Versions of the presentation were provided to Defence before the summit, enabling Defence to provide input on the content prior to the meeting.⁶⁴

2.45 To prepare internally for the meeting, Defence held a one-day pre-summit workshop on 12 October 2016.⁶⁵ The merits and risks of each option for the facilities were discussed and a strategy was developed for the summit.⁶⁶ The strategy stated that Defence would advise Thales of its intention to 'explore the ... Thales option and its merits and opportunities' for beyond June 2020. The strategy also stated that a Defence-Thales charter should be developed, and that the key 'next steps' post-summit included the following.

- Use the Charter to establish principles for a working group of Defence and Thales personnel to develop a path forward from Dec 2016 to June 2017 (to start with).
- Identify that a "marching pause" is required between now [October 2016] and Dec 2016 when Defence will have confirmed (in principle) a sole source approach.

2.46 The strategy further stated that the proposed charter 'shall contain off ramps in case progress is not being achieved, that lead to alternative open source sourcing process (and extension of the SMIC).' Materials distributed by CASG's Explosive Materiel Branch to Defence personnel to support the workshop, included:

- a Defence-developed issues paper (discussed in paragraphs 2.21 to 2.23)⁶⁷;

64 A version of the presentation was provided to Defence on 25 August 2016 and updated versions were provided on 28 September and 5 October 2016. The presentation stated that Defence and Thales would 'work collaboratively on a new contractual model for managing and transforming the sites beyond 2020.'

65 Defence's Head Joint Systems directed that a workshop be conducted to examine the Thales presentation using 'Smart Buyer principles', to inform a recommended strategy for the discussions with Thales. Defence records indicate that the Explosive Materiel Branch received internal advice that the workshop achieved the intent of a 'kick-off meeting' but did not cover 'all areas of risk that would be reviewed at a typical Smart Buyer Risk workshop.' See paragraph 3.7 and footnotes 57, 85 and 93.

66 The consideration of risks associated with each option was informed by the analysis undertaken by the RAND Corporation during the DMMA process, as well as the November 2013 Gate Review recommendations.

67 This paper formed the basis for the 'sponsor's paper' presented by Deputy Secretary CASG to the IC in December 2016 (see paragraph 2.53) and advice to the Minister for Defence Industry between May and June 2017 (see paragraphs 2.68–2.71).

- a Thales-developed ‘draft Joint Directive’⁶⁸; and
- Defence analysis of the Thales presentation.

2.47 The Explosive Ordnance Summit was held on 13 October 2016 and attended by senior representatives from Defence and Thales.

2.48 The summit minutes indicate that the matters set out in the various background papers were discussed, including the design of future contractual arrangements with performance-based tenure extensions. It was agreed that the interim contract would be used as a starting point for development of future contractual arrangements and that a ‘terms of agreement’ should be drafted to support the development of an ‘evolved SMIC [the interim contract]’ with a target completion date of December 2017. The minutes also stated that:

HJS [Head Joint Systems] acknowledged the various options for consideration for the ownership and operation of the factories, and taking into account MHF [Major Hazard Facilities] licensing complications, along with Thales competence demonstrated over previous commercial arrangements, that Defence’s preference would be to progress a Government Owned Contractor Operated (GOCO-T) arrangement with Thales into the future.

2.49 These representations were made prior to final government decision-making and, as outlined by Defence’s BPG (see paragraph 2.40), could have been perceived as committing Defence and government to a course of action that had not been officially endorsed or approved.

2.50 Defence records indicate that Defence’s engagement with Thales regarding the future contractual model continued following the summit in October 2016 and up to December 2016, when the IC considered and approved CASG’s proposal to sole source to Thales. In November 2016, a Defence official sought assistance from, and provided information to, Thales on: the development of internal advice to the IC; Defence committee processes; and internal Defence thinking and positioning.⁶⁹ Government information of this sort is normally considered confidential and these exchanges evidenced unethical conduct.

2.51 While planning activities for the procurement had commenced by March 2016, Defence did not implement project or procurement specific probity arrangements until July 2018, over two years later (see paragraph 4.15). Defence did not assess the probity risks or remind those involved in the procurement activities of their probity obligations before July 2018 and did not clearly differentiate between BAU engagement with Thales and its procurement planning activities.⁷⁰

68 The draft Joint Directive set out: objectives to be achieved in developing a future contracting solution, governance arrangements to support achievement of the objectives, reporting arrangements, and principles to inform development of a future contracting solution. The ‘draft Joint Directive’ was provided to Defence by Thales on 5 October 2016 with the presentation discussed at paragraph 2.44

69 A further email exchange involving the same Defence official soliciting a gift from a senior Thales representative is discussed in paragraphs 4.6 to 4.8.

70 In Auditor-General Report No.15 2021–22 *Department of Defence’s Procurement of Six Evolved Cape Class Patrol Boats*, the ANAO made similar observations in paragraphs 2.81 to 2.84.

Was the decision to conduct a sole source process with the incumbent operator informed by appropriate advice and analysis?

Defence's advice to the IC in December 2016 and the Minister for Defence Industry in mid-2017 on the decision to sole source was not complete. The advice did not address the legal basis for the procurement method, the risks associated with a sole source procurement approach, or value for money issues — including how Defence expected to achieve value for money and maintain commercial leverage in the context of a sole source procurement. When the IC approved the sole source procurement method in December 2016, Defence had not estimated the value of the procurement. This was not consistent with the CPR requirement to estimate the value of a procurement before a decision on the procurement method is made.

2.52 The DPPM included the following guidance between April 2017 and June 2021 relevant to adopting a sole source procurement approach:

Whilst early contractor selection and sole source procurement can also be an effective and efficient execution strategy in appropriate cases, it should not be used solely to avoid the need for competitive tendering, especially when a viable competition can be held. Sound commercial judgment, not convenience, should determine the right approach.⁷¹

Defence Investment Committee consideration — December 2016

2.53 On 9 December 2016, Deputy Secretary CASG, as the Capability Sponsor, presented the IC with options for the future of the factories and a recommended approach. The options presented were consistent with those developed in mid-2016 (see paragraphs 2.21 to 2.23): a government-owned contractor-operated (GOCO) model with the incumbent operator, Thales, or a new operator; disposal of the factories by abandonment⁷²; a government-owned government-operated (GOGO) model⁷³; and selling the factories to adopt a contractor-owned contractor-operated (COCO) model.⁷⁴ All options apart from the GOCO model were 'not recommended'. The recommended approach comprised the following.

1. That the Mulwala propellant and explosives factories and the Benalla munitions factory be retained in Defence ownership as strategic capability enablers.
2. That the current Government Owned Contractor operated arrangement be continued.
3. That the tenure of the current operator of the Mulwala and Benalla factories — Thales Australia — be extended within a revised strategic partner framework.
4. That CASG continue to provide management of the contractual matters, on behalf of VCDF [Vice Chief of the Defence Force] Group, as the Capability Sponsor.

71 Similar guidance was included in Defence's Complex Procurement Guide during the same period.

72 The paper stated that this would result in around 600 direct job losses, the loss of domestic munitions manufacturing expertise, and significant costs for the remediation of environmental contamination and the immediate demolition of buildings that would become susceptible to self-detonation when not in active use.

73 The paper stated that this model was not practicable under the APS staffing cap at the time and would entail Defence accepting significant responsibility for the operation and management of the factories' Major Hazard Facility licences.

74 The paper stated that the DMMA process had established that this model would only be viable with substantial ongoing government investment to sustain the operation of the facilities, and therefore, there was little difference between this option and the recommended model.

2.54 The IC was advised that the recommended approach would mitigate supply chain risks and reduce shelf-life wastage associated with the stockpiling of munitions to meet preparedness requirements.

2.55 The sponsor's paper stated that government had consistently indicated a preference to retain the factories as strategic assets, investing approximately \$1.8 billion since 1999. The paper also stated that the previous DMMA procurement process had established the following.

- That 'all potential commercial options to operate the factories would require ongoing Government subsidies to remain competitive in the world market'.
- That 'it would take at least two years to transition the Thales "know-how" in manufacturing, qualifying and certifying propellant, explosives and munitions to any new contractor'.
- That 'there is no expertise in Australia in the operation and maintenance of the factories as Major Hazard Facilities outside of Thales.'

2.56 As discussed in paragraph 2.37, risks associated with sole sourcing to Thales had been documented between July and September 2016 in the draft Preliminary Procurement Strategy. Those risks were not outlined in the sponsor's paper to the IC. The term 'value for money' did not appear in the sponsor's paper and the advice did not address:

- whether the conditions for a sole source procurement in the CPRs and Defence procurement guidance could be satisfied by Defence;
- the DMMA RFP evaluation findings (discussed in paragraph 2.6);
- the market's capacity to competitively respond to a procurement;
- the estimated value of the proposed procurement (a CPR requirement)⁷⁵; or
- how commercial leverage would be maintained and value for money achieved by Defence in a sole source arrangement.⁷⁶

2.57 The IC was also not advised of Thales' role in developing the paper (see paragraph 2.50).

2.58 In its comments on the December 2016 advice to the IC, Defence's Contestability Division observed that the 'value for money proposition of the contracts for Mulwala and Benalla [had] not been tested for more than 10 years', and by 2025 — when the first 'rolling wave extension' under the new Strategic Partnership Agreement would be likely — the contract 'will not have been competitively tested in over twenty years.'⁷⁷ The Contestability Division also stated that the new

75 Paragraph 9.2 of the July 2014 CPRs, which were in effect at the time of the IC's decision, stated that the: expected value of a *procurement* **must** be estimated before a decision on the procurement method is made. The expected value is the maximum value (including GST) of the proposed *contract*, including options, extensions, renewals or other mechanisms that may be executed over the life of the *contract* [emphasis in original].

76 Paragraph 3.2 of the 2014 CPRs, applicable at the time, stated that '[a]chieving value for money is the core rule of the CPRs', regardless of the procurement method.

77 Contestability Division was established in February 2016 in response to a recommendation of the *First Principles Review* that 'a strong and credible internal contestability function be built ... with responsibility for strategic contestability, scope, technical and cost contestability'. See Department of Defence, *First Principles Review*, 1 April 2015, available from <https://www.defence.gov.au/about/reviews-inquiries/first-principles-review-creating-one-defence> [accessed 12 January 2024].

arrangements should 'involve periodic market testing, to assure value for money from an otherwise perpetual monopoly'.⁷⁸

2.59 The IC agreed on 19 December 2016 to the capability sponsor's recommendations and noted that: 'the Defence position is that retaining these facilities is as per the Government Direction to do so'; and the ministerial submission to the Minister for Defence 'should clearly articulate the costs associated with the facilities, the contract and the potential remediation costs down stream.'

2.60 The IC also noted that 'the contract needs to be market tested at an appropriate future point' and 'that the approach to and timing of the next wave of large investment in the facilities needs to be understood by Defence as a part of the planning.' No timeframe for doing so was proposed in the sponsor's paper or by the IC. The IC's decision to approve the use of a sole source procurement method was not consistent with the CPR requirement to estimate the value of a procurement before selecting the method.

Recommendation no. 2

2.61 The Department of Defence, including its relevant governance committees, ensure that when planning procurements, the department estimates the maximum value (including GST) of the proposed contract, including options, extensions, renewals or other mechanisms that may be executed over the life of the contract, before a decision on the procurement method is made.

Department of Defence response: Agreed.

2.62 *Defence advises that its current Defence Commercial Framework requires officials to comply with Commonwealth Procurement Rules, including paragraphs 9.2–9.6. Defence is reviewing the One Defence Capability System (ODCS) governance and processes to reinforce these requirements.*

2.63 Defence's substantive risk identification activities for the procurement were conducted between late 2017 and mid-2018 (discussed from paragraphs 3.7 to 3.11). These activities considered risks that had not previously been documented or included in advice prepared for the IC in December 2016 or the subsequent ministerial advice in mid-2017 (discussed at paragraphs 2.68 to 2.71). On that basis, Defence cannot clearly demonstrate that its selection of the procurement method was 'properly informed about the risks associated with the procurement', as required by the DPPM, or that its advice to decision-makers on risk was complete or timely. Timely risk assessment and high quality advice to decision-makers was important in the context of a Defence procurement planning process that had signalled to the incumbent facilities operator, Thales, that it could expect to be approached as the only tenderer for a long-term contract, as part of a sole source procurement.⁷⁹

⁷⁸ Advice provided to Deputy Secretary CASG prior to the IC meeting stated that it was not an appropriate time to competitively test the market due to the new propellant factory delivered under the Mulwala Redevelopment Project being in the late stages of industrialisation.

⁷⁹ See paragraphs 2.48 to 2.49.

Recommendation no. 3

2.64 The Department of Defence, including its relevant governance committees, ensure that advice to decision-makers on complex procurements is informed by timely risk assessment processes that are commensurate with the scale, scope and risk of the relevant procurement.

Department of Defence response: *Agreed.*

2.65 *Defence will strengthen its policies in relation to governance committees' consideration of risk.*

2.66 *Defence is reviewing the One Defence Capability System (ODCS) governance and processes to reinforce these requirements.*

2.67 *Defence will continue to ensure it provides timely and accurate advice to decision makers on procurements, commensurate with the scale scope and risk of the relevant procurement activities.*

Advice to the minister on sole sourcing

2.68 On 24 May 2017, Defence advised the Minister for Defence Industry that it had reviewed options for the future of the factories and recommended that the minister agree to the factories being retained under a government-owned contractor-operated model. Defence also requested that the minister note that Defence would enter negotiations with Thales to replace the interim contract with 'a more strategic long-term arrangement'.

2.69 Defence's advice outlined options consistent with those presented to the IC in December 2016 and the propositions considered to have been established by the DMMA. The advice to the minister did not address: the risks with a sole source procurement approach identified by Defence over time; or value for money considerations such as how commercial leverage would be maintained or value for money achieved by Defence in the context of a sole source arrangement. Defence noted that the annual cost of operating the facilities was approximately \$65 million per annum and advised that 'a full assessment of the financial implications will be undertaken once contract negotiations for the operation of the two factories post-2020 have been finalised'.

2.70 At the minister's request, Defence provided the following supplementary advice to the minister in June 2017, regarding third party access rights to the facilities and the nature of the proposed long-term strategic relationship with Thales.

- Defence had the right to mandate sub-leases to third parties and was openly supportive of third parties establishing a presence at the sites, to decrease the cost of ownership and increase competition.
- Sub-lessees would be required to pay a reasonable rent that would offset Defence's facilities operations payment and would operate under the Major Hazard Facility licence maintained by Thales as principal lessee.⁸⁰

80 Defence had assessed Thales as 'the only commercial entity in Australia with the current competency to manage these sites and maintain the Major Hazard Facility licences'.

- Defence noted that the proposed strategic long-term arrangements with Thales were based on lessons learnt from the 2015 interim contract, the DMMA project and a recent 'Smart Buyer' workshop.

2.71 The minister noted that the information in this advice supplemented the information provided on 24 May 2017 and asked to be informed of any companies that approach Defence with an interest in co-locating at the facilities.

3. Establishment of the 2020–30 arrangements

Areas examined

This chapter examines whether the Department of Defence (Defence) conducted an effective sole source procurement process to establish the 2020–30 contractual arrangements.

Conclusion

Defence's conduct of the sole source procurement process to establish the 2020–30 contractual arrangements was partly effective. Risk assessments were not timely and appropriate records for key meetings with Thales during the tender process were not developed or retained by Defence. After assessing Thales' tender response as not being value for money in October 2019, Defence proceeded to contract negotiations in December 2019 notwithstanding internal advice that Defence was at a disadvantage in such negotiations due to timing pressures.

The negotiated outcomes were not fully consistent with Defence's objectives and success criteria. Defence's approach to negotiating the contract in accordance with high-level issues reduced the line of sight between the request for tender (RFT) requirements and the negotiated outcomes. Defence's advice to ministers on the tender and contract negotiations did not inform them of the extent of tender non-compliance, basis of the decision to proceed to negotiations, or 'very high risk' nature of the negotiation schedule.

Areas for improvement

The ANAO made three recommendations aimed at improving Defence's management of probity risks and its records management practices in the procurement context and increasing the line of sight between RFT requirements and the negotiated outcomes in tender processes.

3.1 Defence's implementation of the sole source procurement process to establish the 2020–30 Strategic Domestic Munitions Manufacturing (SDMM) contract with Thales was subject to the *Commonwealth Procurement Rules* (CPRs) and Defence's internal procurement policy — the Defence Procurement Policy Manual (DPPM).

3.2 Defence has established a range of internal guidance, which gives effect to these requirements and encourage compliance with the intent of the principles-based elements of the CPRs.⁸¹ The ANAO examined whether Defence's procurement process for the SDMM was in accordance with procurement requirements and consistent with Defence's internal policies.

Were procurement planning activities timely and in accordance with relevant procurement requirements?

Defence's procurement planning activities were not timely. Prior to mid-2017, Defence's planning had largely focussed on seeking approval by June 2017 to inform Thales of the arrangements for the facilities beyond June 2020 (as required of Defence under the interim contract) and to enable collaborative contract development with Thales to commence. Defence's advice to decision-makers was not informed by the results of key planning processes, as required by the CPRs and Defence's procurement policy framework. These key processes

81 Relevant guidance included Defence's Complex Procurement Guide (CPG) — first released in April 2017; Collaborative Contracting Better Practice Guide; Early Industry Engagement Better Practice Guide; and Defence's 'Smart Buyer' guidance — progressively released from May 2016.

were not conducted until after December 2016 when the sole source procurement method was approved, and included:

- the progressive development of Defence’s requirements for the facilities between March 2017 and July 2019, with assistance from Thales; and
- internal workshops between October 2017 and May 2018, which identified risks that had not been previously documented. Defence did not develop a risk management plan to actively manage those risks.

3.3 As discussed in Chapter 2 (at paragraphs 2.14 to 2.71), Defence had commenced, in mid-2016, its planning activities for the procurement process which led to the 2020–30 SDMM contract. The next stages of the procurement were conducted between January 2017 and August 2018 and included the following.

- Development of the project and procurement governance documents required by Defence’s procurement manual.
- Refinement of the procurement approach, including the proposed contracting model.
- Co-development with Thales of a set of principles to guide development of the future contract and inform the tender request documentation.

Requirements definition and risk assessment

3.4 When the SDMM procurement planning activities commenced in mid-2016, the DPPM outlined that the ‘initial step in any procurement process is requirement identification and development’, with the level of rigour applied to this process to be commensurate with the complexity of the procurement. After identifying that requirement, a Procurement Plan was to be developed ‘detailing how that requirement [would] be satisfied.’

Defence’s requirements

3.5 As discussed at paragraph 2.59, the Defence Investment Committee (IC) approved a sole source process in December 2016 and the Minister for Defence Industry was advised of that approach in May 2017 (see paragraph 2.68). An initial ‘Endorsement to Proceed’ (EtP) was obtained in August 2018, followed by a second EtP in July 2019. The DPPM requirements for an EtP process are discussed in paragraphs 3.28 to 3.31.

3.6 Defence’s policy framework (in effect at the time) outlined that the requirements for procurement activities should be clearly defined in advance of IC consideration (Gate 0) and prior to the EtP. As Defence had not fully developed its requirements by Gate 0 or the August 2018 EtP, it revisited the requirements several times and continued to define them until the ‘Objectives and Success Criteria’ for the procurement were approved as part of a second EtP in July 2019 (see paragraphs 3.36 to 3.37). This process involved providing information to and inviting input from Thales, as follows.

- Between November 2016 and February 2017 — using material it had developed for the ‘Ordnance Summit’ as a basis, Defence and Thales co-developed a draft terms paper to set out ‘some “parameters” to assist in guiding the contract development’ for the 2020–30

SDMM contract. Further co-development of this document continued until at least September 2017.⁸²

- On 7 March 2017 — Defence and Thales attended a ‘Future Domestic Munitions Arrangements Strategy Workshop’ facilitated by KPMG. Defence records indicate that topics of discussion included: identifying success criteria for the new contract; strengths, weaknesses, risks, and opportunities under the interim contract; and next steps, including a high-level schedule for the planned procurement.
- On 13 September 2017 — Defence advised Thales that the government had endorsed entering discussions with Thales to jointly develop and negotiate a long-term strategic agreement for the operation of the facilities beyond June 2020. The advice noted that Defence was determining its requirements and engagement strategy for the future arrangement and would invite Thales to enter discussions with Defence in due course.
- Between October 2017 and August 2018 (when the EtP was signed) — Defence developed project governance documents and held internal planning workshops to identify lessons learnt from the 2015 interim contract and to examine potential multi-tenancy arrangements. During this period Defence also co-developed an SDMM Process Document and heads of agreement with Thales⁸³, which set out an intended collaborative contracting approach.⁸⁴

Risk assessment

3.7 Prior to the December 2016 IC decision to sole source, Defence’s approach to risk assessment focussed on the risks associated with changing from the incumbent operator. Broader environmental scanning and risk profiling was not conducted prior to Gate 0, as envisaged by Defence’s policy framework. Rather, Defence’s substantive risk identification activities did not commence until late 2017 and involved:

- developing a ‘Drivers, Risks, Assumptions and Issues Log’ (DRAIL) in October 2017. This was last updated on 7 August 2018, prior to the initial EtP on 28 August 2018 (see paragraphs 3.28 to 3.31);
- conducting internal workshops in October 2017, to discuss lessons learnt from the 2015 interim contract and potential multi-tenancy arrangements, and between February and May 2018, which included ‘Smart Buyer’ workshops⁸⁵; and
- developing an ‘SDMM [Strategic Domestic Munitions Manufacturing] — Explosive Materiel Branch Risk Log’ in September 2018, which included the risks documented in the DRAIL. This log was used to assess and manage procurement risks through to June 2020 (when the contract was signed).

82 The summit is discussed at paragraph 2.48.

83 The heads of agreement was based on the draft terms paper and was executed by Defence and Thales in September 2018 (see paragraphs 3.6 and 3.34).

84 Defence records indicate that development of these documents and the draft Project Execution Strategy was informed by consideration of a 2016 exposure draft of a Defence ‘Collaborative Contracting Better Practice Guide’, which was subsequently finalised and released in September 2017.

85 Defence guidance on the Smart Buyer process outlines a 14-week process prior to Gate 0/IC approval. For the SDMM project, Defence conducted the required ‘kick-off meeting’ and two-day risk workshop over three days between 19 February and 13 March 2018. The Project Execution Strategy was developed in the approved format between November 2016 and May 2018. There was no evidence of other key steps of the process being undertaken, such as a ‘Red Team review of the execution strategy.’

3.8 As these risk identification activities did not commence until well after the sole source procurement method was decided, a number of risks and issues were identified that had not previously been documented or included in advice prepared for the IC in December 2016 or the minister in mid-2017. These risks and issues included the following.

- By basing the new arrangements for the facilities beyond June 2020 largely upon a modified version of the 2015 interim contractual arrangements, the following issues needed to be managed:
 - Defence did not have clearly defined objectives or an acquisition strategy prior to entering into the 2015 interim contract, with expected savings and efficiencies remaining undefined;
 - a number of Thales' deliverables under the 2015 interim contract remained outstanding as at February 2018, including intellectual property and an efficiency improvement plan. To mitigate this risk, the DRAIL recorded that Defence would present 'pre-conditions' (with associated deadlines) to Thales required to be resolved before agreement was reached on the SDMM contract⁸⁶; and
 - increased complexity with potential multi-tenancy arrangements introduced.⁸⁷
- Defence risked losing competitive tension throughout the SDMM process, particularly if negotiations extended 'beyond the deadline for Defence to commence a competitive tender activity'.⁸⁸ Defence noted that 'stalling tactics from Thales' may seek to push negotiations beyond that deadline in order 'to pressure Defence to accept a less than optimal position, particularly on the financial outcomes.'⁸⁹
- The collaborative contracting process lacked clarity and previous negotiations with Thales had been characterised with misalignment between what was agreed 'around the table' and the deliverable subsequently provided by Thales. Defence noted a need to clearly understand and mitigate the risks of this process, including probity considerations.⁹⁰
- There were challenges for Defence in being 'an informed Owner and Buyer of products from the facilities' as 'CASG has lost considerable expertise in the management and operation of the facilities.'

86 Key pre-conditions for negotiation included: clarifying and agreeing the SDMM contract scope and requirements; a facilities management strategy; resolving outstanding SMIC (2015 interim contract) deliverables and remediation activities; strategic management and relationship governance; defining estate management responsibilities and Defence requirements; stakeholder mapping and engagement; and transition planning.

87 Defence noted benefits of a multi-tenant model, including lower operating costs, increased product range and Australian content, and risks such as increases in cost and Major Hazard Facility management complexity.

88 This deadline had previously been identified by Defence as 30 June 2017.

89 Defence also noted that there was a need to remain aware of Thales' engagement across Defence, as it was 'particularly active at the senior CASG and political levels.'

90 In the October 2017 internal workshops, Defence noted that '[w]ith Thales there was often agreement around the table as to what was to occur, and then when the deliverable was provided by Thales it didn't align – then there was time pressure to reach a solution.' The Source Evaluation Report for the 2015 interim contract procurement recorded that Thales had withdrawn from numerous contractual positions jointly developed with Defence and introduced new issues.

3.9 The CPRs emphasise the importance of effective risk management in procurement.⁹¹ Consistent with this, the DPPM (that was in effect in 2017) stated that for all procurements at or above the relevant procurement threshold⁹², Defence officials must:

- undertake a risk assessment so that they are properly informed about the risks associated with the procurement; and
- subject to the risk assessment, develop and implement a risk management plan to manage the risks.

3.10 The next steps agreed in May 2018 following the workshops involved progressing the development of key documents for approval and preparing for contract negotiations. The workshop records indicated the following.

- It was agreed that there would be merit in an overarching deed (signed by Deputy Secretary CASG and the Thales CEO) covering the broad Defence-Thales relationship to support the development of a more holistic and strategic approach to managing Defence's relationship with Thales, and its various contracts across the ADF.
- An 'integrated, fully-resourced master schedule should be developed, with that schedule to include the internal Defence activities, and progressively, the arrangements for engagement with Thales and their key milestones.'

3.11 Defence did not develop a risk management plan.⁹³ This approach was not consistent with Defence's internal policy requirements or the CPR requirement to establish risk assessment and management processes commensurate with the scale, scope and risk of the procurement.

Procurement plan and strategies

3.12 For procurements valued at or above \$200,000 (GST inclusive), Defence's policy framework required that a written procurement plan be developed commensurate with the scale, scope and risk of the procurement, and which takes account of the procurement life cycle, including the cost of ownership and disposal considerations.⁹⁴

3.13 Defence's framework also made provision for a 'procurement strategy', which in some guidance was referred to interchangeably with 'procurement plan'. Various documents — a number of which were called strategies — were prepared over time, which addressed aspects of procurement planning. These documents included: strategies developed for IC consideration in December 2016 (discussed in paragraphs 2.35 to 2.37); a 'Future of Benalla and Mulwala

91 Both the March 2017 and January 2018 versions of the CPRs set out that:

Relevant entities **must** establish processes for the identification, analysis, allocation and treatment of risk when conducting a *procurement*. The effort directed to risk assessment and management should be commensurate with the scale, scope and risk of the *procurement*. [emphasis in original].

92 The relevant procurement threshold refers to the thresholds for application of Division 2 of the CPRs.

93 The August 2018 EtP stated that no risk assessment had been conducted because the 'Smart Buyer process has sufficiently addressed Risk for this stage of the Procurement Process' and that '[f]urther risk assessment activity will be undertaken using the Risks listed in the DRAIL as a starting point.' As discussed in paragraph 3.7, Defence developed a DRAIL in August 2018 and transferred these risks to an 'SDMM – Explosive Materiel Branch Risk Log' in September 2018, which was maintained until June 2020.

94 The April 2017 DPPM drew a distinction between the business case which 'explains why a procurement is being undertaken, including its value proposition' and the procurement plan which 'explains how the procurement is to be undertaken.'

Implementation Plan’ — developed between December 2016 and September 2017⁹⁵; and a Support Procurement Strategy (SPS)⁹⁶ — approved by the Director-General Explosive Materiel on 23 August 2018 as part of the initial EtP, enabling collaborative contract development with Thales to commence (this process is discussed further from paragraph 3.35).

3.14 The SPS listed contracting options and a proposed strategy to engage with Thales to establish new long-term strategic arrangements.⁹⁷ It also did the following.

- Anticipated a collaborative contracting process and contract signature by late 2019 or early 2020 to allow sufficient time to transition from the 2015 interim contract.
- Listed key assumptions including: no change to the strategic direction provided by government; an ongoing requirement for the facilities to produce key munitions for the ADF; and a need to enable munitions manufacturing by non-Thales tenants where mandated by Defence.⁹⁸
- Outlined key drivers including: expiry of the 2015 interim contract on 30 June 2020; government policy to retain the facilities and maximise their use; the facilities being defined as key capability enablers; and further explosive ordnance (EO) enterprise elements potentially being included in future arrangements.

3.15 This collection of documents does not clearly demonstrate implementation of Defence’s expectation in its Complex Procurement Guide (CPG) that a complex procurement process would be informed by an overarching procurement strategy supported by subordinate procurement planning documents.⁹⁹

Unsolicited proposal from NIOA

3.16 Defence records indicate that between mid-2016 and mid-2017, all analyses had strongly supported, and all efforts were directed towards, conducting a sole source procurement to enter into long-term arrangements with Thales, the incumbent operator.¹⁰⁰ Defence had consistently advised decision-makers that Thales was the only viable operator for the facilities.¹⁰¹

95 The plan’s attachments included a version of the 2016 Project Execution Strategy and the draft terms paper discussed at paragraphs 2.35 and 3.6 and footnote 68. The plan was initially developed in December 2016 to support Defence’s implementation of the approach agreed by the IC in December 2016.

96 The Support Procurement Strategy template is typically used for major sustainment procurements, and according to the CPG, satisfies ‘the requirement for a documented procurement strategy.’

97 The contracting options outlined were: a single consolidated facilities management, operation and munitions supply contract; one contract for facilities management and operations and one for munitions supply; and one contract for facilities management, one for facilities operation, and one for munitions supply. The document noted that Defence’s preferred contracting option would be informed by discussion with the Capability Manager and other Defence stakeholders, as well as with Thales and other potential multi-tenants.

98 The SPS stated that Defence’s intention was to establish a multi-tenancy model under which tenants could sign sub-lease or licence arrangements with Thales, or enter into separate leasing arrangements with Defence, to occupy parts of the sites.

99 The CPG was first released in April 2017 ‘to provide guidance to Defence officials on how to undertake more complex procurement activities in the Defence environment.’ Like the DPPM, the CPG placed strong emphasis on the planning phase of a procurement, noting that if ‘planning is done well, it will usually lead to better value for money outcomes, including reduced procurement related risks for Defence and a shorter and more efficient procurement process.’

100 See paragraphs 2.21 to 2.71.

101 See paragraphs 2.53 to 2.71.

3.17 In May 2017, Defence received an ‘unsolicited proposal’ from NIOA, a Defence firm, which led to an adjustment of the broad approach. Defence records indicate that NIOA met with Defence ministers and Defence officials several times between late March and mid-May 2017 to discuss NIOA potentially purchasing the Benalla site or establishing a new munitions factory in western Queensland.¹⁰²

3.18 NIOA provided a proposal to Defence, on 18 May 2017, for use of the Benalla and Mulwala facilities under a ‘common user facility model’. Defence records indicate that there was further communication between Defence and NIOA between June and August 2017, including the provision of supplementary information on the May 2017 proposal. This included ‘enhanced AIC [Australian Industry Capability] content & export opportunities’ and a further multi-phased proposal relating to tenancy at the Benalla site, including for refurbishment of certain types of ammunition. NIOA updated its proposal in September 2017 and again in December 2017.

Announcement of ‘new strategic arrangement’ with Thales

3.19 As outlined in paragraph 2.71, the Minister for Defence Industry had requested in June 2017 to be informed of companies interested in co-locating at the facilities. Defence provided the minister with an update on 4 January 2018, outlining potential sub-lease operators at the facilities. The advice included that: a BAE Systems Australia sub-lease from Thales at Mulwala was in place and would continue under any new contractual arrangement; and NIOA had provided an unsolicited proposal to Defence to sub-lease precincts at Benalla based on Defence and commercial opportunities, including remediation of various types of Defence ammunition.¹⁰³

3.20 Defence’s 4 January 2018 briefing also noted the minister’s ‘previous agreement’ to Defence entering into negotiations with Thales (see paragraph 2.68) and provided a draft media release ‘to publicly announce the decision’, which included outlining that the new arrangements included ‘provisions for other companies to sub-lease precincts at either location.’¹⁰⁴

3.21 On 8 January 2018, the acting Director-General Explosive Materiel approved Defence supporting the first phase of NIOA’s proposal and commencing discussions with NIOA and Thales as soon as possible, with a view to signing sub-leases and any required tripartite agreements by early 2018. Defence advised Thales in writing of NIOA’s proposal on 16 January 2018.¹⁰⁵ On 6 February 2018 — 18 months before the RFT was released and 22 months before contract negotiations were commenced — the Minister for Defence Industry announced that Defence would enter negotiations with Thales for the continued management and operation of the factories. The minister outlined that:

102 Defence records indicate that the first meeting occurred on 28 March 2017, between NIOA and the offices of the Minister for Defence Industry and Minister for Defence Personnel and Veterans’ Affairs.

103 Defence’s advice noted that NIOA held intellectual property rights for these ammunition types and that Defence would otherwise need to either send the items overseas for remediation, or dispose of and replace the ammunition, at greater cost.

104 Defence also advised that it had received an ‘inquiry from the Australian Manufacturers Workers Union in regards to the future of the facilities’ and that the media release would respond to its concerns.

105 A meeting was held between Defence, NIOA and Thales on 15 June 2018 to agree the form of lease. However, agreement was not reached due to Thales proposing a direct sub-lease or licence between Thales and NIOA, while NIOA proposed a lease between itself and Defence.

negotiations with Thales will see a new strategic arrangement for the management and operation of the factories, improving price competitiveness and increasing export potential for Australian-manufactured ammunition and explosive products.¹⁰⁶

3.22 Defence's 4 January 2018 advice to the minister did not indicate how Defence planned to maintain competitive pressure in the subsequent negotiation phase, to achieve value-for-money for the Commonwealth in the context of a preferred outcome being publicly announced and in the absence of a competitive process.¹⁰⁷

Finalisation of NIOA's proposal

3.23 The NIOA sublease and refurbishment work was announced by the Minister for Defence on 4 September 2018.¹⁰⁸ This followed extensive tri-party negotiations with Thales and NIOA during 2017 and 2018 to agree on the division of the purpose-built buildings at the Benalla site.

3.24 Defence analysis of NIOA's proposal stated that NIOA was 'the largest supplier of munitions and weapons by value to Australia' and 'the only likely credible major direct tenant'.¹⁰⁹

3.25 Defence wrote to Thales on 10 August 2018 advising that the sub-lease was to be supported by a tripartite deed between Defence, NIOA and Thales regulating use of the Benalla facility. Defence further advised that an early draft of the deed would be provided to Thales in the week commencing 13 August 2018. To enable NIOA to commence remediation work between late 2018 and early 2019, Defence envisaged executing the sub-lease and deed in September 2018.

3.26 NIOA met with Defence on 9 August 2018 and offered to refurbish certain ammunition types at no cost, an offer it confirmed in writing on 13 August 2018.¹¹⁰ Defence accepted NIOA's offer on 29 November 2018. NIOA's proposal also included a long-term direct lease of part of the Benalla site from 1 July 2020 (see paragraphs 3.38 to 3.40).

3.27 Defence met with Thales on 24 August and 19 October 2018 to discuss NIOA's proposal and the proposed sub-lease and deed. Thales executed the sub-lease and tripartite deed on 15 November 2018. On 27 November 2018, the First Assistant Secretary Joint Systems (FAS Joint Systems) approved entering into the sub-lease and tripartite deed and on 29 November 2018,

106 Minister for Defence Industry, 'Job certainty for Benalla and Mulwala munitions factories', media release, 6 February 2018, available from <https://www.minister.defence.gov.au/media-releases/2018-02-06/job-certainty-benalla-and-mulwala-munitions-factories> [accessed 20 October 2023].

107 Paragraph 4.4 of the 2017 CPRs, in effect to 31 December 2017, stated that: 'Achieving value for money is the core rule of the CPRs.' Paragraph 3.2 of the 2018 CPRs, in effect from 1 January 2018, also stated this.

108 Minister for Defence, 'NIOA - a perfect fit for Benalla Munitions Factory', 4 September 2018, media release, available from <https://www.minister.defence.gov.au/media-releases/2018-09-04/nioa-perfect-fit-benalla-munitions-factory> [accessed 26 February 2024].

109 The analysis also stated that Winchester Australia, 'the only other credible small arms munitions manufacturer in Australia besides Thales', had announced on 10 December 2018 that it would cease manufacturing in Australia. The analysis stated further that NIOA's teaming arrangements with international and global munitions companies made it likely that NIOA would be able to access original equipment manufacturer intellectual property (IP) and manufacture munitions required by the ADF at Benalla. Defence considered Thales, in contrast, to be limited in the range of new munitions which it was able to manufacture due to original equipment manufacturers' refusal to share their IP and technical data with Thales.

110 The two bodies of work agreed to by Defence were undertaken as nil-cost procurements under paragraph 2.6 of the 2017 CPRs due to falling within two categories designated by Defence's Secretary in the 1 April 2017 DPPM: Federal Supply Code 13 Ammunition and Explosives and Operation of Government-owned Facilities. See paragraphs 2.27 to 2.30 of this audit for discussion of the CPR exemption in paragraph 2.6 of the CPRs, which remained unchanged between the 2014 and 2017 CPRs.

Defence provided NIOA with signed copies of the deed and the sub-lease for signature by NIOA. Copies of the executed sub-lease and deed were distributed to Thales and NIOA on 21 December 2018.

Endorsement to Proceed

3.28 The December 2017 DPPM required that an EtP be obtained prior to approaching the market for procurements to establish a standing offer arrangement, and for all other procurements valued at or above \$200,000 (GST inclusive). An EtP was approved by the Director-General Explosive Materiel on 23 August 2018. It did not include approval of the RFT documentation, which is the usual practice. The EtP stated that as the procurement was ‘subject to collaborative development with the intended contractor’ and a complete set of request documentation would be completed ‘later in the collaborative contract development process’.

3.29 The EtP further stated that collaboration with Thales was to be ‘in accordance with the strategy outlined in the Support Procurement Strategy.’ The EtP also stated that new contractual arrangements would be signed by late 2019 to allow sufficient time to transition from the 2015 interim contract and, based on the procurement’s expected total value of \$550 million (GST inclusive), would need to be approved by the IC and Ministers for Defence and Finance. The estimated procurement value was based on facility operation expenditure under the interim contract at August 2018.

3.30 The EtP set out that the procurement: was to be conducted by ‘Limited Tender Single Supplier’ as a measure under paragraph 2.6 of the CPRs, and was exempt from Division 2 of the CPRs due to falling under the following categories determined to be exempt by Defence’s secretary: procurement of goods under US Federal Supply Code 13 Ammunition and Explosives; and procurement of services related to the operation of government-owned facilities.¹¹¹

3.31 Achieving value for money, the core rule of the CPRs, applies to all procurement activities, including sole source arrangements. In response to how the non-competitive procurement method would deliver value for money, the EtP set out that:

The collaborative contract development approach will enable Defence and Thales to put in place a more long-term strategic arrangement than is possible under the existing five-year interim contract. Defence will aim to ensure that cost efficiencies continue to be identified (as already occurs under SMIC [Strategic Munitions Interim Contract]) which can lead to reductions in cost or to improvements in the capability over time. Defence will also create an arrangement by which other parties can establish facilities to manufacture munitions or provide related services by taking up tenancies within, or adjacent to, the Mulwala and Benalla Facilities to increase competition in the longer term. This latter aspect will need to be negotiated into the new contractual provisions so that Defence can mandate an additional tenancy where it is strategically appropriate to do so.

111 Where it applies, Division 2 of the CPRs defines the circumstances in which a limited tender over the procurement threshold may be undertaken. Categories of goods and services determined by Defence’s Secretary to be exempt from normal requirements under paragraph 2.6 of the CPRs were outlined in the December 2017 version of the DPPM, which applied at the time.

Did Defence develop the request for tender materials effectively?

Defence undertook a process which included the principal elements of a complex procurement as set out in Defence's procurement policy framework, including an Endorsement to Proceed (EtP), a RFT process and detailed contract negotiations. A feature of Defence's process was the high level of interaction with Thales on the contents of the RFT before and after it was issued on 16 August 2019, including during the tender response period. Defence's Complex Procurement Guide (CPG) identified 'probity risks inherent in such activities' and stated that relevant engagement processes and activities 'should be planned and conducted with appropriate specialist support.' Seeking specialist advice on the propriety and defensibility of its approach would have been prudent and consistent with the PGPA Act duty that officials exercise care and diligence.

Development of the request for tender

3.32 Defence developed the request documentation and other process documents, including the tender evaluation plan, between August 2018 and August 2019. This included continuing to refine its requirements and procurement approach, culminating in development of an 'Objectives and Success Criteria' document. This iterative approach necessitated obtaining multiple approvals to approach the market (the revised EtP is discussed at paragraph 3.43).

3.33 To guide engagement with Thales throughout the collaborative contracting process, two documents were executed in mid-September 2018. The first was a deed of undertaking, signed by Thales on 10 September 2018. In signing the deed, Thales agreed to participate in the process at its own cost, in accordance with an 'SDMM Process Document'.¹¹² The following 'collaborative principles' were set out in the process document: accountability, collaboration, communication, continuous improvement, and respect.

3.34 The deed was to be read in conjunction with the heads of agreement, executed on 14 September 2018, which set out 'guidance on how the parties agree to behave in the development of long-term arrangements for the continued operation of the Facilities' and key proposed contractual terms. Both the deed and heads of agreement referred to an indicative schedule, including commencing engagement with Thales in August 2018, completion of negotiations in Quarter 2 2019, contract signature in Quarter 4 2019, and a contract operative date of 1 July 2020.

3.35 Between October 2018 and August 2019, Defence and Thales participated in 28 collaborative workshops to support development of the RFT. Monthly 'Principals Meetings' at the SES Band 2 and Thales Vice President level were also held during this period. As Defence had not settled the contracting model for the proposed contract, in January 2019 Defence also held internal workshops on the contracting model and leasing models for multi-tenancy arrangements. Discussions included whether to develop a new contract, an enhanced version of the Strategic Munitions Interim Contract (SMIC, or 2015 interim contract) with a five-year term, or extend the

¹¹² The document outlined that the process might include: an initial meeting between Defence and Thales to provide an overview of the process; discussion on a draft heads of agreement; a series of workshops on issues and risks associated with the proposed arrangements and Defence's requirements for an RFT; Defence Smart Buyer processes; requests for information by Defence; submission of additional information by Thales; and discussions with Thales during any evaluation or negotiation process.

SMIC by 5 years.¹¹³ In relation to multi-tenancy models, it was noted that NIOA had requested a direct lease, an approach which was noted to have been accepted by FAS Joint Systems and the Director-General Explosive Materiel. It was additionally noted that BAE Systems wanted to retain its sub-lease from Thales at Mulwala and possibly expand.

3.36 FAS Joint Systems and Commander Joint Logistics approved a document titled 'Objectives and Success Criteria', on 5 and 9 July 2019 respectively. The document set out seven objectives and 15 'success criteria' for the SDMM procurement, and Defence's proposed multi-tenancy model.¹¹⁴ The success criteria included that the contract would provide 'improved value for money to Defence compared to the SMIC Agreement' and 'an incentivized and ongoing cost reduction framework'.

3.37 The objectives and success criteria were used to develop the RFT, which was issued to Thales in August 2019. By late October 2019, shortcomings in these criteria were identified by Defence's Tender Evaluation Steering Group (TESG), with the TESG noting that when the success criteria were developed in July 2019, Defence was 'still working through what it wanted from the capability' and was 'largely seeking to create a contract that could be reformed through the initial period of the contract term'.

Approval of the multi-tenancy approach and building allocation at Benalla

3.38 On 15 July 2019, FAS Joint Systems approved Defence's preferred multi-tenancy approach for the Benalla site beyond June 2020, which included issuing Thales with a secondary lease encompassing production buildings and storage magazines. Under the approach, Defence intended to transfer these buildings and magazines to NIOA under a secondary lease, commencing on 1 July 2022.

3.39 The advice to FAS Joint Systems indicated that approval had been received from the Minister for Defence Industry on 12 December 2018 to enter into negotiations with NIOA for a contract and direct lease for part of the Benalla site from 1 July 2020. Thales had been advised by Defence in a letter dated 2 October 2018 that Defence had received an unsolicited proposal for a direct lease of part of the Benalla facility. The letter had advised that Defence expected a decision on whether to enter into negotiations to be made by the end of October 2018 and if progressed the proposal would be discussed with Thales as part of collaborative discussions.

3.40 The advice to FAS Joint Systems also stated that following receipt of the minister's approval, Defence had requested that Thales and NIOA develop a joint plan for utilisation of the buildings within NIOA's proposed tenancy, and had held four collaborative workshops with Thales and NIOA between March and June 2019 to support this activity. These workshops had resulted in Thales and

113 During the workshops it was noted that Thales' expertise was more related to Mulwala than Benalla and it was suggested that the sites could be managed separately, with another company managing Benalla. It was also noted that Defence needed the flexibility to have Thales vacate Benalla or part of the site and that it was possible to have multiple Major Hazard Facility licences at Benalla.

114 These were: 'Maintain the safe operation of the Facilities'; 'Support Defence's preparedness requirements through surety of munitions supply for selected ADF munitions'; 'Expand the range of activities able to be undertaken for the ADF at the Facilities including In Service Surveillance (ISS) testing and selected de-militarisation activities'; 'Provide enhanced munitions production capability and capacity'; 'Incentivise improved outcomes for Defence that deliver increased value for money'; 'Establish an environment that identifies and encourages investment in the Facilities which enables enhanced use of the facilities on a "best for Defence" basis while also considering and recognising non-ADF impetus'; and 'Ensure that the Facilities' manufacturing capabilities are aligned with the Munitions and Small Arms Sovereign Industrial Capability Priority (SICP) and support Defence exports'.

NIOA reaching agreement on nine buildings, with Thales and NIOA providing competing proposals for the remaining 11 buildings to Defence for final allocation. Defence records indicate that Defence advised Thales and NIOA at a 'Principals Meeting' on 16 July 2019 of its decision regarding tenancy boundaries. On 2 August 2019, Defence advised NIOA of its intention to collaboratively develop an RFT for the Munitions Manufacturing Arrangement.

Early release of RFT documentation and release of the RFT exposure draft

3.41 RFT documentation was released to Thales between 26 April and 28 June 2019. A full 'without prejudice' exposure draft of the RFT was released between 16 and 24 July 2019. A period of 49 days was provided for Thales to respond to the RFT, commencing on 19 July 2019.

3.42 Changes to the RFT were made up to 2 August 2019 and included the following.

- Profit at risk margins were increased from 30 per cent to 100 per cent for consistency with the Australian Standard for Defence Contracting (ASDEFCON) templates.
- There was a revised approach to performance measures, to accommodate tenure reduction.
- There were updated Intellectual Property (IP) and Technical Data (TD) provisions to enable the Commonwealth to own all IP created under the contract by default.

Revised Endorsement to Proceed and approval of the RFT release

3.43 On 15 August 2019, the Director-General Explosive Materiel approved a revised EtP. The revised EtP noted that Defence would enter into a collaborative partnership with Thales and was in discussion with NIOA to lease part of the Benalla site under a multi-tenancy arrangement. The EtP further noted that a separate sole sourced limited tender was expected to be released to NIOA in September 2019. The revised EtP stated that Defence was seeking to achieve better value for money through reduced cost of ownership, more effective operations and maintenance, cost transparencies and an improved performance management framework.

3.44 The revised EtP included a revised estimated contract value of \$660 million (GST inclusive) over the minimum 10-year life of the arrangement with Thales, with a total estimated value of \$990 million (GST inclusive) over the maximum 15-year term. Tenure beyond the minimum term was noted to be subject to award term mechanisms within the contract. It was also noted that available funding was for the initial 10-year period only, and that Minister for Finance approval would be needed to fund additional tenure. The revised EtP further noted that in addition to the estimated value, munitions orders placed with Thales would be undertaken using a survey and quote mechanism in the contract and funded separately by Army, Navy and Air Force.

3.45 Defence provided advice to the Minister for Defence Industry on 5 August 2019 on procurement process progress and its intention to release the SDMM RFT on 9 August 2019. The advice noted Defence's intention to release a sole source RFT to NIOA in the second half of 2019 and that the minister had met with NIOA on 3 July 2019. Defence's substantive advice was that:

Whilst the Defence industry landscape has matured since the original decision to select Thales, Thales is still assessed as the least risk option. No other Australian company has the proven capability and experience to operate the Mulwala and Benalla factories.

3.46 The minister noted Defence's advice on 12 August 2019.

3.47 On 14 August 2019, a decision brief was provided to the Director-General Explosive Materiel outlining a number of risks (discussed at paragraph 3.48) and seeking approval to release the SDMM RFT. Defence did not retain a signed copy of the brief, notwithstanding CPR requirements for maintaining records of relevant approvals and decisions. The 2019 CPRs stated that:

- 7.2 *Officials must* maintain for each *procurement* a level of documentation commensurate with the scale, scope and risk of the procurement.
- 7.3 Documentation should provide accurate and concise information on:
 - a. the requirement for the *procurement*;
 - b. the process that was followed;
 - c. how value for money was considered and achieved;
 - d. relevant approvals; and
 - e. relevant decisions and the basis of those decisions. [emphasis in original]¹¹⁵

3.48 The unsigned version of the brief included an endorsing minute prepared by Materiel Procurement Branch (MPB) in CASG, which stated that ‘the Initial Term is a substantial period compared to other sustainment projects’. The MPB minute also noted that ‘the timeframe to reach contract signature is considered high risk given the limited leverage Defence has over Thales, being the incumbent and being a sole source activity.’ MPB recommended that ‘alternate plans / options be developed to mitigate an event of a delay to contract signature’, with any option required to be implemented before 1 July 2020 because Defence did not have automatic extension rights under the SMIC.

Request for tender

3.49 A limited RFT was released to Thales via AusTender on 16 August 2019, along with a matrix of changes between the exposure drafts and final versions of documents released in the RFT.¹¹⁶ Following release of the RFT, one addendum was issued via AusTender on 13 September 2019 comprising 71 amendments to the RFT documentation, along with a matrix of changes, with amendments largely in response to suggestions or questions by Thales.

3.50 The Conditions of Tender (CoT) set out five non-weighted criteria (listed in Table 3.1) and provided for Defence to do the following at any time during the RFT: obtain additional information relevant to Thales’ tender; use material responding to one criterion in the evaluation of another; seek clarification or additional information from, and enter into discussions with Thales concerning its tender; and conduct pre-negotiation discussions.

3.51 The CoT provided for pre-negotiation discussions with Thales regarding: clarification; submission of additional information; discussions with Thales; provision of feedback to Thales; workshops; site visits; improved definition and refinement of draft plans and programs; assessment of capabilities; and submission of a final tender upon completion of discussions. The CoT also provided for Defence to make changes to the draft contract during pre-negotiation discussions, and to require Thales to amend its tender to reflect the changes.

¹¹⁵ The 2019 CPRs came into effect on 20 April 2019.

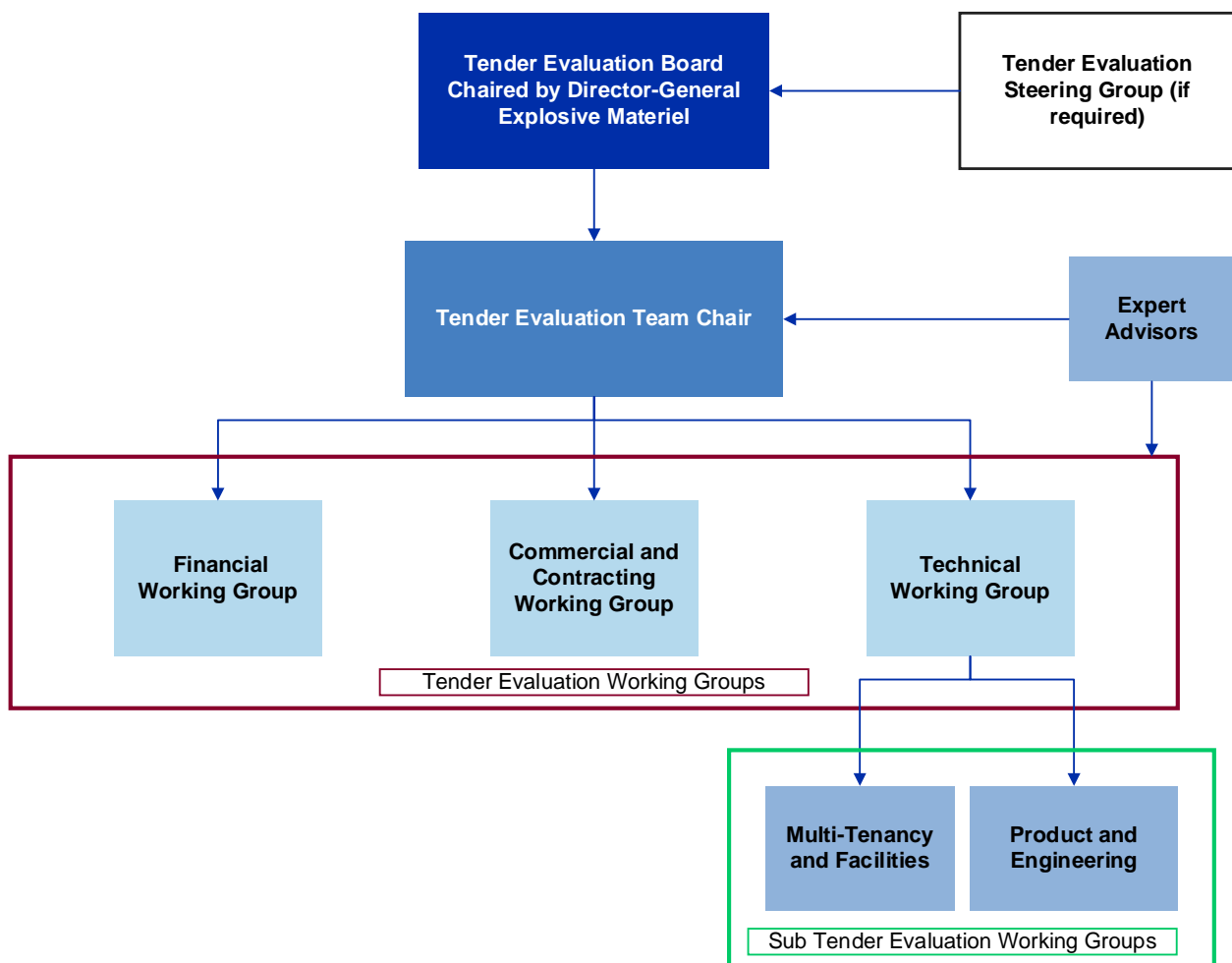
¹¹⁶ Thales was formally advised by Defence at a meeting on 2 August 2019 of amendments between the exposure drafts and final versions of RFT documents.

Tender evaluation plan

3.52 Defence's procurement policy framework required a tender evaluation plan (TEP) to be prepared for all competitive procurement processes, commensurate with the scale, scope and risk of the procurement.

3.53 While not required for this sole source procurement, a TEP for the SDMM procurement was signed on 18 September 2019 by the Director-General Explosive Materiel. During the tender evaluation process an updated TEP, which added a Tender Evaluation Steering Group (TESG) to the Tender Evaluation Organisation (TEO), was signed by the Director-General Explosive Materiel on 31 October 2019. The TEP established the TEO and an Expert Advisory Panel (see Figure 3.1).

Figure 3.1: Elements of the Tender Evaluation Organisation outlined in the revised Tender Evaluation Plan



Note: The colour red in the figure identifies the Tender Evaluation Working Groups.

The colour green in the figure identifies the Sub Tender Evaluation Working Groups.

Source: ANAO analysis of Defence records.

3.54 Both versions of the TEP set out roles, responsibilities, and the process to be followed for tender evaluation. The TEP required all TEO members and expert advisers to complete a tender evaluation conflict of interest declaration. Defence contractors were also required to complete both a conflict of interest declaration and a deed of confidentiality. Prior to the receipt of tenders, the TEB Chair was to brief all TEO members on the TEP, including requirements pertaining to: probity,

ethics and fair dealing; conflicts of interest; and security, privacy and confidentiality. Defence records indicate that the required briefing occurred on 10 September 2019. Defence's management of probity is further discussed from paragraph 4.3.

3.55 There were a number of key differences between the 18 September 2019 and 31 October 2019 versions of the TEP issued by Defence, relating to the scope of pre-negotiation discussions between Defence and the tenderer, the management of clarification questions and unsolicited information during the evaluation, and the status of the Source Evaluation Report (SER) if it was unable to clearly recommend an outcome. The revised 31 October 2019 TEP broadened the scope of issues that could be resolved after the SER had been signed, which had been limited in the original TEP to minor issues of form and non-substantial areas.

3.56 In relation to clarification questions and unsolicited information provided during the tender evaluation, the 18 September 2019 version of the TEP stated that:

- written clarification questions 'must be approved for release by the TEB Chair (which is to be reviewed by MPB) and must not be designed to solicit new information from the tenderer.'¹¹⁷
- Any unsolicited information received from the tenderer after the tender closing date was to be passed to the TEB Chair.¹¹⁸

3.57 The revised TEP of 31 October 2019 reassigned responsibility for managing clarification questions and unsolicited information to the Tender Evaluation Team Chair. The October 2019 TEP also added an additional paragraph relating to the SER, as follows:

Where the SER is unable to clearly recommend an outcome, the SER is to be an **interim report** pending further consideration and activities conducted by the project team to enable a full recommendation to be presented to the Delegate (emphasis added).

3.58 The SER did not fully document the extent of the changes between the September 2019 and October 2019 versions of the TEP, noting only that 'the SDMM TEP was amended to include the use of a TESG'.¹¹⁹

Collaborating with a tenderer in the course of an active tender

3.59 As discussed, a feature of Defence's procurement process was ongoing engagement with Thales on the contents of the RFT before and after it was issued, including during the tender response period. There is some evidence that this engagement helped Defence improve certain Commonwealth commercial levers in the proposed contract. However, Defence's Complex Procurement Guide (CPG) identified 'probity risks inherent in such activities' and stated that:

for any procurement that involves high levels of tenderer interaction (for example, one that involves interactive clarification workshops during tender evaluations, or utilises a comprehensive ODIA [offer definition and improvement activities]), the engagement process and activities should be planned and conducted with appropriate specialist support, for example, contracting officers

117 The September 2019 TEP stated that if 'the tenderer's response to a clarifying question foreshadows a change in scope, schedule or cost, the TEB Chair will determine whether the information is admissible for evaluation purposes.'

118 The TEB Chair was to 'determine whether such information should be quarantined or evaluated consistent with the principles for the handling of late tenders outlined in the request documentation.'

119 As outlined at paragraph 3.75 Defence decided on 17 October 2019 that a TESG be established.

(or an independent legal process or probity adviser) to assist with managing the probity risks inherent in such activities.[footnote]

[footnote] This point is made not with the intent of discouraging the use of the interactive tendering processes but to ensure that when these practices are adopted they are conducted with the necessary awareness of associated probity risks and in a manner that appropriately manages these risks while retaining the value of the engagement activity. The aim in all cases is to achieve an appropriate balance between probity risks and the risks to the procurement arising from significant areas of uncertainty (for example, technical, cost, schedule) which the engagement activity aims to address.

3.60 Defence did not seek specialist advice on the propriety and defensibility of its approach, including from the Department of Finance as necessary, which would have been prudent for a procurement process that involved high levels of tenderer interaction as described in the CPG. Doing so would have supported Defence's ability to demonstrate compliance with the general duty of officials, set out in subsection 25(1) of the *Public Governance, Performance and Accountability Act 2013* (PGPA Act), to exercise the degree of care and diligence that a reasonable person would exercise if they were an official of the entity and occupied that position.

Recommendation no. 4

3.61 The Department of Defence ensure that when it undertakes complex procurements with high levels of tenderer interaction, it seeks appropriate specialist advice, including from the Department of Finance as necessary.

Department of Defence response: *Agreed.*

3.62 *Defence officials, when undertaking complex procurements with high levels of tenderer interaction, should seek appropriate specialist advice.*

3.63 *Defence will strengthen guidance within the Defence Procurement Manual and Probity Toolkit in relation to seeking specialist advice when undertaking complex procurements with a high probity risk.*

Did Defence conduct an effective tender evaluation process that supported the achievement of value for money outcomes?

By October 2019, Defence had determined that Thales' tender response was not value for money due to assessing the proposal as 'Deficient – Significant' with 'High' risk against all five evaluation criteria and identifying 199 non-compliances against the RFT. Defence considered the number of non-compliances to be 'unprecedented' and initially agreed, internally, to extend the interim contract with Thales to allow sufficient time to negotiate the non-compliances with the RFT.

Following senior-level discussions in November 2019 with Thales, Defence decided to conclude the evaluation process on 4 December 2019 and proceed to contract negotiations. This decision was made notwithstanding internal advice that Defence was at a disadvantage in negotiations due to timing pressures. Defence's internal advice considered that it had no 'off-ramps' due to the impending expiry of the interim contract on 30 June 2020. Defence did not clearly document

the basis for reducing risk ratings against all the evaluation criteria from 'High' to 'Medium', following the senior-level discussions with Thales.

Defence did not prepare or retain appropriate records for key meetings with Thales during the tender where the identified risks required active Defence management in the Commonwealth interest. Defence's approach to record keeping was not consistent with requirements in the relevant Communications Plan, internal procurement advice, guidance in the CPG, or the CPRs.

3.64 Thales' tender response for the SDMM process was received on 26 September 2019. Between 27 September 2019 and 4 December 2019 Defence evaluated the response against the criteria set out in the TEP and prepared a source selection recommendation for the delegate.

3.65 During the tender evaluation, Defence submitted 53 clarification questions to Thales on topics including: the Mulwala Redevelopment Project¹²⁰; subcontractors; technical data and intellectual property; facilities operating costs and return on facilities operating costs; ADF and non-ADF pricing; and Australian Industry Capability.

Source Evaluation Report

3.66 The December 2019 Source Evaluation Report (SER) stated that 'the large volume of complex non-compliances [with the RFT] was not anticipated [by Defence], noting the collaborative activities undertaken prior to and during the RFT drafting period'. As discussed in footnote 90, Defence had previously documented that non-compliances were a feature of Thales' response to the 2015 interim contract Request for Formal Offer. Defence's internal planning workshops held in late 2017 and early 2018 (discussed in paragraph 3.7) had subsequently identified the risk of Defence losing competitive tension during the SDMM process.

3.67 The SER set out the Tender Evaluation Board's (TEB) overall assessment of tender compliance and risk for each of the five criteria outlined in the RFT and TEP. In October 2019, the Tender Evaluation Working Groups (TEWGs) assessed Thales's RFT response as 'Deficient–Significant' with high risk against each of the five evaluation criteria, finding the response to be deficient against 58 of the 71 sub-criteria (82 per cent), with 'extreme' risks recorded against 12 sub-criteria and 'high' risks recorded against 31 sub-criteria. The ratings against the sub-criteria remained unchanged in the December 2019 SER, which assessed Thales' response as 'Deficient – Significant' with medium risk against the five evaluation criteria.¹²¹ A summary of the results is set out in Table 3.1.

120 See footnotes 24, 36 and 78.

121 See footnote 129 and paragraph 3.96.

Table 3.1: Defence evaluation of Thales tender response against the evaluation criteria

Evaluation criteria	No. of sub-criteria			No. of risks			
	Total	Compliant	Deficient	Extreme	High	Medium	Low
The suitability of the tenderer to perform the obligations of the Contract	13	5	8	2	3	4	4
The extent to which the tendered solution is capable of meeting the requirements of the Statement of Work	22	1	21	2	15	4	1
The extent to which the tenderer's response is compliant with the draft Conditions of Contract	12	2	10	5	2	3	2
The acceptability of any risk associated with entering into the Contract with the tenderer	8	3	5	3	1	3	1
The tendered prices and pricing structure for the draft Contract, and the tendered response to reducing the total cost of ownership to Defence	16	2	14	0	10	3	3
Total	71	13	58	12	31	17	11

Source: ANAO analysis of Defence records.

3.68 The December 2019 SER stated that:

the contractual terms and conditions sought by Thales in its written response would constitute a significant departure from those released by the Commonwealth in the RFT. The approach adopted by Thales in its written response is one which:

- a. limits the Commonwealth's flexibility in the utilisation of the Facilities by:
 - (i) restricting the way that a third party can access the Facilities;
 - (ii) introducing compensation provisions if Thales' commercial operations are impacted due to Commonwealth direction; and
 - (iii) introducing additional obligations and costs for the provision of technical data and transfer of risk to the Commonwealth.

...

- c. reduces the efficacy of the performance management framework to such an extent that it will be ineffective in incentivising Thales to perform well in contract and reduce cost over the Term (by reducing the level of performance required to deliver capability and earn Award terms, removing incentives for efficiency and by de-linking termination rights due to poor performance); and
- d. demonstrates a lack of recognition of the need to achieve transformation to a 'best for Defence' focus and reform the business.

3.69 The December 2019 SER also stated that the TEWG's had initially concluded that:

Overall, with consideration to the technical and commercial compliance and risk ratings of the tendered response, the cost as tendered, and the stated level of compliance with the RFT, the written tender response from Thales was assessed by the TEWG's as not representing value for money against the RFT requirements.

Thales presentation in October 2019

3.70 On 1 October 2019, as provided for in the TEP and CoT¹²², Thales presented to Defence on its tender response. The presentation outlined key differences between: the SMIC and the proposed SDMM contract; key elements of Thales' tender response; a summary of non-compliances with the RFT; cost benchmarking information¹²³; and a proposed 'way forward'.

3.71 While Defence retained a copy of Thales' October 2019 presentation, Defence advised the ANAO in March 2024 that it did not retain any other record of the meeting, notwithstanding that this was required by the SDMM Communications Plan (see paragraph 4.15) and the 27 September 2019 TEP required the presentation to be recorded. In the context of a complex and material sole

122 The TEP stated the following:

The TEB Chair can invite the tenderer to provide a presentation on its tender response. This presentation will be managed by the TEB Chair with the TEO and will be recorded to ensure adequate probity. Such an event will not be an opportunity for the tender to amend their tender response.

123 Thales' presentation compared its proposed contract price to similar facilities in the United States at Radford and Holston and referred to a finding of the 2013 RAND report that direct munition prices from the facilities were comparable to international burdened prices.

source procurement, the CPRs establish an expectation that officials maintain appropriate records, including documentation of discussions with a preferred tenderer during an active tender.¹²⁴

3.72 Prior to the 1 October 2019 presentation by Thales, MPB had provided advice to Defence personnel involved in the procurement which emphasised the importance of being ‘cognisant of probity issues’ in their communications with Thales and the need to keep appropriate records. This included the following advice in April 2019.

I would seek that any meeting where formal minutes are not done, that the Cth [Commonwealth] provide the other party with a high level summary of that meeting. This is particularly important where something is agreed / action required based on the other parties [sic] assumptions or statements made during the meeting.

Further where open type statements are made within emails (from NIOA / Thales) that refer to earlier phone calls which are not fully representative of the discussions, that these are clarified asap ... Finally any meeting with NIOA / Thales should have two Cth attendees. Where this is not possible meeting notes / actions discussed should at least be advised by the Cth, if only at a summary level.

3.73 Following the presentation on 1 October 2019, MPB noted that ‘on the face of it Thales appear to have ignored [the Commonwealth’s] stated position’s / requirements [sic]’. MPB provided the following advice to the TET Chair and the TEWG leads.

If ... fundamental non compliances are identified these should be raised ASAP [as soon as possible] to the TEB, seeking their input / way forward. As a minimum Thales should be put on notice about those fundamental non compliances (at a high level) at that point and not wait until the end of evaluation process to ensure our bargaining power / negotiation positions are not lost / lessened by Cth [Commonwealth] inaction

3.74 MPB also advised on 1 October 2019 that where aspects of the tender response were ‘ambiguous’ or ‘factually unclear’, Defence should submit clarification questions to Thales and, following clarification, note any residual issues in the evaluation assessment.¹²⁵

Non-compliances against the RFT

3.75 Between 4 and 31 October 2019, the TET Chair provided several internal briefings on the early evaluation findings to the TEB and other senior Defence personnel.¹²⁶ The briefings covered key gaps and areas of concern in Thales’ RFT response, as identified by the TEWGs, and possible impacts to the SDMM schedule and included the following key updates.

- FAS Joint Systems was advised on 15 October 2019 that Thales’ proposal ‘appear[ed] to be based on SMIC but with additional restrictions that are designed to ensure Thales’

124 Paragraph 7.2 of the 2019 CPRs required that: ‘Officials **must** maintain for each *procurement* a level of documentation commensurate with the scale, scope and risk of the procurement [emphasis in original].’

125 The July 2019 version of Defence’s Complex Procurement Guide stated that:

While less common, ODIA may also be conducted with a single tenderer (where, for example, there is a clear leading tender but in respect of which material uncertainty exists with respect to one or more areas of the tender that needs to be resolved before progressing to either confirming the tenderer as preferred or contract negotiations with the preferred tenderer). Accordingly, ODIA with one tenderer will normally be the exception rather than the rule.

126 Attendees at briefings included the TEB Chair (Director-General Explosive Materiel), FAS Joint Systems, the acting Group Business Manager CASG and the FAS Procurement and Contracting CASG.

continued and unimpeded control of the facilities to maintain their commercial market whilst sustaining high entry barriers to competitors.’

- At a briefing on 17 October 2019¹²⁷, it was decided that a Tender Evaluation Steering Group (TESG) would be established to ‘provide future strategic advice and direction to the TEO [Tender Evaluation Organisation] and SDMM Project.’ The members of the TESG were FAS Procurement and Contracting, Commander Joint Logistics, and FAS Financial Performance and Management.

3.76 A TESG was convened on 31 October 2019. The meeting minutes record that it was advised that Thales’ RFT response was ‘not as expected and there was a significant difference in the positions of the parties, such that contract negotiations would take an extended period of time to reach an acceptable position.’ The TESG was briefed on the tender evaluation, including key risk areas, and was asked to consider the following as a way forward:

1. Agree there is a potential for negotiation to meet Defence Objectives but that the CoA [Commonwealth of Australia] needs to reset the balance of Power;
2. Agree to Defence Senior Officer (possibly DepSec CAS [Capability Acquisition and Sustainment]) intervention with the Thales Executive to inform them that its current SDMM offer is not in the Commonwealth’s ‘bargaining arena’ and that consequently:
 - a. The Commonwealth needs to extend the SMIC agreement by 6 months to provide sufficient time to negotiate a suitable outcome for both parties,
 - b. the SMIC extension will include the option for Defence, at its discretion, to extend SMIC by a further 18 months for the purpose of undertaking a new market solicitation if there has been unsatisfactory progress in developing a Heads of Agreement (described below),
 - c. The SMIC agreement would need to maintain, as far as practical, the existing SMIC provisions with the exception of including multi-tenancy from mid 2020, and agreement between the parties for the SMIC extension;
3. Agree a proposed way forward for SDMM which is:
 - a. parties to complete a Commercial Heads of Agreement for SDMM within 6 months (i.e. by 30 April 2020 (note this was amended post meeting to 28 Feb 20) [note in original],
 - b. parties to complete SDMM detailed negotiations within 9 months (i.e. by 30 July 2020),
 - c. in the event that agreement is not reached (for Heads of Agreement by 30 April or detailed SDMM contract by 30 June), Defence can take up the additional SMIC extension options, and proceed to a competitive tender for SDMM, aiming to achieve a contract award by 1 July 2022.

3.77 In respect to a possible competitive tender, Defence advice provided to the IC in December 2016 was that Thales was the only viable operator in the market due to there being ‘no expertise in Australia in the operation and maintenance of the factories as Major Hazard Facilities outside of Thales’ (see paragraph 2.55).

3.78 The minutes of the 31 October 2019 TESG meeting noted that the SMIC extension and associated contract value increase would require IC approval and recorded a comment from a TESG member that ‘Thales has the CoA [Commonwealth of Australia] “over a barrel” as the incumbent,

127 FAS Joint Systems had requested that the TET Chair provide this briefing be provided to the acting Group Business Manager CASG and the FAS Procurement and Contracting CASG.

and knowing that the CoA cannot reasonably close down the facilities on 1 July 2020.’ The minutes also recorded that the TESSG supported the evaluation findings, endorsed the proposed way forward, endorsed extending the SMIC while seeking to undertake negotiations and agreed to executive-level discussions with Thales to clarify the offer and establish an agreed way forward.

Executive-level discussions in November and December 2019

3.79 FAS Joint Systems met with Australian Munitions’ (Thales) Managing Director on 6 November 2019 for the purpose of a ‘high-level discussion’. Briefing material prepared to support FAS Joint Systems’ attendance at the meeting noted that:

Thales, as the incumbent, are in a position of power, with schedule slippage in Thales’ favour. Requesting Thales agree to an extension to SMIC will, subject to the identified caveats, shift power to the Commonwealth by providing sanctions for immediate remediation if the parties do not reach agreement on SDMM within six months.

3.80 Defence advised the ANAO in March 2024 that it did not retain the minutes of the 6 November 2019 meeting, notwithstanding that this was required by the SDMM Communications Plan and (as discussed in paragraph 3.71) a CPR expectation. On 8 November 2019, members of the TESSG were however emailed a dot point summary of what was discussed at the meeting on 6 November 2019, which outlined the following.

- Defence advised Thales that the tender response was not as expected by Defence, and Defence had established a steering group as a result. Defence also advised that there was a need to extend the interim contract (including multitenancy arrangements) to provide an opportunity to address the differences between the RFT requirements and Thales’ tender response.
- Thales advised Defence that the majority of non-compliances in its tender response related to areas of the RFT not provided in full to Thales during the collaborative workshops (these workshops were discussed at paragraph 3.35). Thales also advised that ‘the key Thales issues’ — which included intellectual property, the performance management framework and multi-tenancy — ‘were driving the majority of their non-compliances’ and ‘could be resolved quickly’.
- Defence and Thales agreed to: a clarification meeting on 12 November 2019 to discuss how elements of the RFT had influenced Thales’ response; and a further meeting between Deputy Secretary CASG and Thales’ CEO approximately 2 weeks after the clarification meeting.

3.81 Defence met again with Thales on 12 November 2019 as planned.¹²⁸ At that meeting Defence advised Thales that ‘the purpose of the meeting was to understand Thales’ high level drivers and risks behind its tender response’ and that the response ‘was a long way apart from the Commonwealth’s requirements as presented in the RFT.’¹²⁹ Defence also advised Thales that

128 Key issues discussed at the meeting included intellectual property rights, the proposed performance management framework, multi-tenancy arrangements, cost affordability and business model reform.

129 In relation to the outcomes of the 12 November 2019 meeting, the Source Evaluation Report (SER) prepared in December 2019 stated that:

Footnote continued on the next page...

Deputy Secretary CASG and the Thales Executive would discuss the proposed SMIC extension arising from the high number of non-compliances in Thales' tender response at the forthcoming meeting.

3.82 On 15 November 2019, the TEB Chair (the Director-General Explosive Materiel) met with Deputy Secretary CASG to provide an update on the procurement progress. A written brief was provided prior to the meeting. The brief informed Deputy Secretary CASG of the extent of tender non-compliances in Thales' RFT response and matters discussed at the meetings of 6 and 12 November 2019 and noted that negotiations would consequently take longer than expected. Consistent with the agreed way forward (see paragraph 3.76), Deputy Secretary CASG's direct engagement with Thales Australia's CEO was sought to obtain Thales' agreement to extend the SMIC inclusive of multi-tenancy and inform Thales that insufficient progress might result in Defence conducting a competitive tender process. Deputy Secretary CASG agreed to the approach and requested that NIOA be kept informed to avoid a perception that Defence was 'backing Thales over NIOA.'

3.83 A brief prepared to support Deputy Secretary CASG's attendance at the meeting with Thales (held 21 November 2019) stated that notwithstanding the clarification meetings held with Thales to date, it would take time to negotiate the 'unprecedented' volume (39 pages) of 'acknowledged non-compliances' and that the schedule was considered 'high risk'. The brief also noted that '[w]ithout an extension Defence has no off-ramp or leverage over Thales and will continue to be driven by the pending expiry of the existing contract.'

3.84 On 21 November 2019, Deputy Secretary CASG, Commander Joint Logistics and the TEB Chair met with Thales to further clarify Thales' RFT response and agree a way forward, with a view to ensuring the SDMM contract was signed before the SMIC expired on 30 June 2020. The Commander Joint Logistics advised the Chief of Joint Capabilities on 21 November 2019, following the meeting, that 30 January 2020 had been identified as the deadline for completing all negotiations, to provide sufficient time to achieve Defence and government approvals before 30 June 2020. Deputy Secretary CASG directed the TEB Chair to work with Thales to develop a negotiation schedule, by 27 November 2019, to determine whether the 30 January 2020 target date was achievable.

3.85 The advice to the Chief of Joint Capabilities also stated that the alternative option, as agreed by the TESC, involving the interim contract extension (discussed at paragraph 3.76), was raised with Thales during the meeting and that Thales was 'resistant', citing multi-tenancy as a potential obstacle. Defence records indicate that Thales presented a view that extending the interim contract and including multi-tenancy would require as much effort as negotiating the SDMM contract. Defence accepted this view despite identifying the supporting evidence as 'weak'.

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- a. The high-level clarification discussions ... have improved the overall evaluation assessments, although [there are] remaining Deficient – Significant [assessments] against the Evaluation Criteria with Medium Risk; and

- b. The high-level clarification discussions have improved the prospects that a satisfactory agreed position could be negotiated and a VFM [value for money] position reached between the parties.

The December 2019 SER also noted that 'risk might be further reduced if the Commonwealth reconsiders some positions in relation to requirements.'

3.86 Defence records also indicate that for part of the 21 November 2019 meeting with Thales, no Defence officials were present other than Deputy Secretary CASG.¹³⁰ Defence advised the ANAO in March 2024 that it did not retain ‘formal records’ of that meeting. As discussed in paragraph 3.71, this was required by the SDMM Communications Plan, and the CPRs required officials to maintain a level of documentation commensurate with the scale, scope and risk of each procurement.

3.87 In March 2024, Defence provided to the ANAO a Defence official’s handwritten notes dated 22 November 2019, which were taken during a verbal briefing by the TEB Chair on the outcomes of the 21 November 2019 meeting with Thales. These notes pertained to the part of the meeting with Thales attended by the Commander Joint Logistics and the TEB Chair. They did not pertain to the part of the meeting attended solely by Deputy Secretary CASG (see paragraph 3.86). The notes covered issues discussed at the 6 November 2019 meeting (see paragraph 3.80) and were consistent with the advice to the Chief of Joint Capabilities discussed at paragraphs 3.84 to 3.85. In addition, the notes indicated that at the meeting, Defence and Thales agreed:

- to a 45 working day negotiation schedule¹³¹; and
- to cease work on an interim contract extension and prioritise SDMM negotiations.¹³²

3.88 Defence’s June 2020 approval documentation for the SDMM contract (discussed at paragraph 3.128) indicated that at the 21 November 2019 meeting, Thales provided assurances that: the final cost to Defence would not exceed the SMIC per annum cost; a negotiated and affordable position could be reached by 31 January 2020; and ‘a value for money outcome was achievable with both parties committing to focussing on meeting the strategic intent sought under the RFT.’¹³³

3.89 On 25 November 2019, Defence met with Thales to agree the schedule to 31 January 2020 and a list of key issues for negotiation. On 28 November 2019, the TEB Chair emailed to Deputy Secretary CASG the high-level negotiation schedule and a more detailed ‘Blue Line’ schedule (both agreed with Thales). The email included the following advice.

- Negotiations will commence on 2-3 Dec 19 with a ‘negotiations rules’ workshop. The purpose is to align expectations on how to act and to ensure a common understanding of the schedule etc for everyone involved in the negotiations.
- To remove the need to work line by line through the 199 non-compliances the Defence negotiation team will present a proposed position that takes into account Defence’s requirements and the feedback from Thales to the RFT. This will form the basis for the subsequent negotiations.

3.90 Defence records indicate that a further clarification meeting was held between Defence and Thales on 4 December 2019, during which additional financial data was provided by Thales. Defence

130 As discussed in paragraph 3.72, in April 2019, probity advice had been circulated within Defence regarding contractor interactions in the procurement, which stated that ‘any meeting with NIOA / Thales should have two Cth [Commonwealth] attendees’.

131 The December 2019 SER documented that verbal advice was provided by the TEB Chair to the TET Chair that ‘Defence and Thales had agreed to support and resource this very compressed and high risk approach.’

132 The December 2019 SER also stated that it was agreed that a SMIC extension would not be pursued but if negotiations were not completed by 31 January 2020, Defence might consider an extension as a fallback.

133 Defence’s approval documentation also stated that ‘[o]n the basis of those assurances and agreement to an executable engagement program, Deputy Secretary CASG directed the SDMM project office to enter into negotiations.’

could not provide the ANAO with meeting minutes and advised that it did not retain relevant meeting records.

3.91 This approach was inconsistent with guidance in the July 2019 CPG, which stated that good record-keeping during the evaluation process is important to ensure ‘a transparent and defensible audit trail of the evaluation stage of the procurement process.’ The guide also stated that ‘[t]he evaluation team should make sure that all key matters and decisions during the evaluation are recorded, along with the reasons for decisions and recommendations.’

3.92 As discussed in paragraph 3.71, in the context of a complex and material sole source procurement, the CPRs establish an expectation that officials maintain appropriate records, including documentation of discussions with a preferred tenderer during an active tender. Defence considered this procurement high risk for the Commonwealth, not least because timing pressures (relating to expiration of the existing contract in June 2020) were considered to give Thales a negotiation advantage. The four instances where Defence did not prepare or retain relevant records related to key meetings with Thales, where the identified risks required active Defence management in the Commonwealth interest.¹³⁴

3.93 Deficiencies in Defence record-keeping in the procurement context have been reported in other Auditor-General reports.¹³⁵ Given the deficiencies in record keeping identified in this audit report and the long-term nature of the 2020–30 SDMM contract, including the need for future decisions about the contract and the tenancies, Defence should implement measures to ensure compliance with its Records Management Policy over the life of the contract.¹³⁶

Recommendation no. 5

3.94 The Department of Defence ensure compliance with the Defence Records Management Policy and statutory record keeping requirements over the life of the 2020–30 Strategic Domestic Munitions Manufacturing contract, including capturing the rationale for key decisions, maintaining records, and ensuring that records remain accessible over time.

Department of Defence response: *Agreed.*

3.95 *Defence has implemented measures to strengthen governance and ensure accountability across all information assets (records, information and data) throughout the entire information lifecycle in a unified way.*

Approval of the Source Evaluation Report

3.96 On 4 December 2019 the three TEWGs prepared supplementary reports outlining the matters discussed at the meeting of 12 November 2019 (see paragraph 3.81), relevant to each TEWG’s areas of evaluation. These reports did not clearly document the basis for Defence’s decision to reduce the risk ratings against all criteria from ‘High’ to ‘Medium’. The Technical and Commercial

¹³⁴ These deficiencies relate to Defence meetings with Thales held on 1 October 2019, 6 November 2019, 21 November 2019 and 4 December 2019. They are discussed in paragraphs 3.71, 3.80, 3.86 and 3.90.

¹³⁵ Auditor-General Report No.21 2022–23 *Department of Defence’s Procurement of Hunter Class Frigates*, paragraph 2.11.

¹³⁶ *ibid.*, paragraph 2.13. Implementation of such measures would be consistent with a recommendation agreed to by Defence during the ANAO audit of Defence’s Procurement of Hunter Class Frigates.

and Contracting TEWG supplementary reports substantially reproduced relevant sections of the minutes of the 12 November 2019 meeting.

3.97 Defence could not provide the ANAO with the TEB Chair’s acknowledgement of the content of the Technical TEWG supplementary report. Defence advised the ANAO that it did not retain this document. The Financial TEWG supplementary report was not signed and was edited six days after SER approval.

3.98 Defence’s Tender Evaluation BPG, in effect at the time, set out that: ‘The evaluation team should assess risk in accordance with the risk ratings and methodology set out in the TEP’. The BPG also stated that:

The SER (and the TEWG reports) should contain sufficient detail to ensure the source selection recommendation and each of the findings/conclusions are substantiated, defensible and able to withstand challenge and scrutiny.

3.99 Neither the supplementary TEWG reports, nor the SER, documented any revised assessment at a sub-criteria level in accordance with the methodology set out in the TEP.

3.100 The SER was approved on 4 December 2019 by the TEB Chair, the Director-General Explosive Materiel.¹³⁷ In approving the SER, the TEB Chair agreed to commence negotiations as soon as possible to achieve a negotiated contract by 31 January 2020.

Were negotiated outcomes consistent with Defence’s objectives and success criteria?

The negotiated outcomes for the 2020–30 contract were not fully consistent with Defence’s objectives and success criteria approved by Defence in July 2019. At the conclusion of negotiations in February 2020, three of the 15 success criteria aimed at incentivising satisfactory performance and reducing the contract management burden and total cost of ownership for the facilities were reported as not achieved. Defence’s approach to negotiations involved agreeing a schedule and high-level negotiation issues with Thales, to guide negotiations between December 2019 and February 2020. Defence did not systematically address the 199 non-compliances it had identified in Thales’ tender response. This approach reduced the traceability between the RFT requirements, risks and issues identified during tender assessment, and the negotiated outcomes in the agreed contract.

Defence’s advice to its ministers on the tender and 2020–30 contract negotiations did not inform them of key issues such as the extent of tender non-compliance, the basis of the decision to proceed to negotiations, and Defence’s assessment of the ‘very high risk’ nature of the negotiation schedule.

Contract negotiations

3.101 As discussed in paragraphs 3.83 to 3.89, Defence considered that Thales’ tender response included an ‘unprecedented’ number of ‘acknowledged non-compliances’. Defence’s approach was

¹³⁷ Prior to signing the SER, a TEB member emailed the TEB Chair outlining concerns that Defence had deviated from the approach agreed by the TEGS in October 2019 (see paragraphs 3.76 to 3.78) and was proceeding to negotiate in ‘the extant “high risk” timeframe’. The TEB member also noted that the SER was silent on the 18-month extension that had been agreed by the TEGS in October 2019 to enable approaching the market if satisfactory negotiation progress was not achieved.

to develop negotiation positions without systematically addressing the 199 tender non-compliances it had identified (see paragraph 3.89). This approach resulted in limited line of sight between the RFT requirements, risks and issues identified during tender assessment, and negotiated outcomes.

3.102 Defence conducted contract negotiations with Thales in two stages between 5 December 2019 and 19 February 2020. The negotiation process was guided by the following.

- A Contract Negotiation Plan (CNP)¹³⁸ approved by the delegate (FAS Joint Systems) on 5 December 2019, documenting the timeframe and a two-stage negotiation approach.
- A stage one Contract Negotiation Directive (CND), approved by the delegate as an attachment to the CNP on 5 December 2019.
- A stage two CND, endorsed by the delegate on 23 December 2019.

3.103 As outlined by Table 3.2, the CNDs for stages one and two each set out a number of ‘negotiation issues’ and Defence’s ‘intended’ positions for each issue, as well as any ‘limit’ (or fallback) positions where relevant. Defence provided clear and defined directions on its intended positions across 23 issues for stage one negotiations and 42 issues for stage two negotiations. Fallback positions were documented for 16 stage one issues and for 26 stage two issues. The basis and rationale for these positions were not clearly identified in either CND. The stage two CND was informed by the outcomes of the stage one negotiations, and included details on Thales’ preferred position on issues and relevant clauses of the draft contract.

Table 3.2: Number of negotiation issues identified, by contract negotiation stage

Stage	CND approved	Date negotiations commenced	Date negotiations concluded	With fallback positions	No fallback positions	Total negotiation issues
One	5/12/2019	5/12/2019	20/12/2019	16	7	23
Two	23/12/2019	6/01/2020	19/02/2020	26	16	42

Source: ANAO analysis of Defence records.

3.104 An interim Contract Negotiation Report for stage one (stage one report) was finalised on 23 December 2019, as Defence’s report on the outcomes of stage one, to guide remaining negotiations in stage two. In approving the report, FAS Joint Systems noted key issues had been deferred to stage two, increasing schedule pressure in light of the 31 January 2020 date agreed with Thales.

3.105 The stage two CND stated that stage two was to negotiate issues that were not addressed or sufficiently resolved in stage one, and to negotiate new positions developed following stage one.¹³⁹ The ANAO’s analysis indicates that at least 14 (60 per cent) of the 23 stage one negotiation issues remained unresolved in part or in full at the end of stage one. The stage one CND noted that if any issues were to arise outside the scope of the stage two CND, they must be referred to the delegate.

138 The July 2019 DPPM required Defence to document its negotiation strategy in a manner commensurate with the scale, scope and risk of the procurement prior to entering into contract negotiations.

139 An 18 December 2019 draft of the stage two CND included addressing all non-compliances identified in Thales’ tender response in a detailed non-compliance matrix, which was to be used to inform and populate a stage two negotiation matrix. This element was removed from the stage two CND prior to delegate endorsement.

3.106 On 9 January 2020 Defence provided advice to the Ministers for Defence and Defence Industry on the SDMM contract negotiations. The advice did not inform them of key issues arising in the tender and contract negotiations, such as: Defence’s assessment that there had been an ‘unprecedented’ number of tender non-compliances by Thales (see paragraph 3.83); the basis of Defence’s decision to proceed to negotiations (see paragraphs 3.84 to 3.89); or Defence’s assessment of the ‘very high risk’ nature of the negotiation schedule agreed with Thales (see paragraph 3.89). More complete draft advice had been prepared by Defence in November 2019 for ministers, to advise on these matters, but that version was not provided to them.

Negotiation outcomes

3.107 A final negotiation outcomes report was approved by FAS Joint Systems on 24 February 2020. The stage one and two CNDs stated that the outcomes reports were to outline the position reached for each issue, highlighting any significant differences with the RFT draft contract, pre-negotiation expectations or relevant CND aspects. Neither report outlined whether there were any of these differences.

3.108 The final outcomes report stated that Defence had achieved at least the minimum fallback position or its revised positions for all stage two issues. Negotiations for some issues extended beyond the scope of the stage two CND and were escalated for approval as required. These issues were referred to the delegate, FAS Joint Systems, who had given approval on 14 February 2020 for seven intended positions and five fallback positions to be amended across the following issues.

- Indemnities and liabilities in the context of multi-tenant arrangements.
- Cost affordability.
- ADF minimum order value.¹⁴⁰
- Facilities operation payment schedule.¹⁴¹
- The performance management framework and awarding contract extensions.
- Use of excess facility capacity.¹⁴²
- Right of first offer on a limited range of new products.¹⁴³

3.109 Table 3.3 summarises the ANAO’s analysis of Defence’s achievement of its intended stage two positions across the seven categories listed in the final negotiation outcomes report.

140 The limit position authorised in the CND was a non-cumulative minimum order value (MOV) of \$25 million for each of years three to 10. The delegate cleared the lead negotiator to offer MOV of up to \$25 million per year to gain a commensurate reduction in facilities operation payment. The report noted there was effectively no risk or additional cost because the actual orders for the life of the contract were estimated to exceed \$25 million per year.

141 The Commonwealth agreed to half yearly payments in advance as part of a package of concessions to reduce Thales’ ADF Products net profit margin by two per cent.

142 Defence agreed to a pre-approval for Thales to enter into commercial agreements for products currently manufactured to a predetermined cap during the first year of the contract.

143 Defence agreed to Thales having the right of first offer on selected ADF munitions not currently manufactured in Australia (as at February 2020) should these be manufactured in Australia in the future. This was among the concessions agreed in return for a reduction in the net profit margin for ADF Products (see footnote 141).

3.110 The final negotiation outcomes report outlined that Defence had achieved all seven objectives and 12 of the 15 success criteria approved by FAS Joint Systems and the Commander Joint Logistics in July 2019 (discussed at paragraph 3.36). The following three criteria were reported as not achieved.

- ‘Reduced cost of ownership compared to the existing SMIC’.
- ‘Supports a Rolling Wave tenure of an additional 5 years to the base term of 10 years’.
- Reduction of:
the Commonwealth's contract management burden by using existing plans already produced by Thales and better apportioning roles and responsibilities within Defence under the “One Defence” model, notably increasing [Estate and Infrastructure Group] involvement and responsibility.

Table 3.3: Final negotiated outcomes by category, compared against Defence's Stage 2 intended and fallback positions

Negotiated outcome	Commercial	Performance	Financial	Multi-tenancy	Facilities/ properties	Definitions	Products/ engineering	Total	
								No.	%
At or above the original intended position	6	7	1	2	1	1	1	19	45
As per an amended position	–	–	4 ^a	1	1	–	–	6	14
Intent of original intended position achieved ^b	1	–	–	–	1	–	3	5	12
Below the original intended position but at or above the original fallback position	1	–	1	2	–	–	–	4	10
As per the original fallback position	2	–	–	–	1	–	–	3	7
Below the original fallback position	1	–	–	2	–	–	–	3	7
Not applicable ^c	1	–	–	–	–	–	1	2	5
Total	12	7	6	7	4	1	5	42	100

Note a: As reported by Defence in the 24 February 2020 Stage 2 Contract Negotiation Outcome Report.

Note b: For one of these four financial negotiation issues, Defence reported in the stage two outcome report that the intent of the original position had been achieved. This differed from the ANAO's analysis (as reflected in Table 3.3), which found that the relevant outcome was the result of an amended intended position.

Note c: These issues were recorded by Defence as either 'no further action' or 'resolved through clarification' and 'not a negotiation issue' in the 24 February 2020 Stage 2 Contract Negotiation Outcome Report.

Source: ANAO analysis of Defence records.

3.111 Following the conclusion of negotiations and prior to the finalisation of the stage two final outcomes report, a final TEGS meeting was held on 20 February 2020. During the meeting the TEB Chair acknowledged that it was ‘entirely likely’ that a ‘materially better’ outcome would have been achieved if there had been more time to negotiate. The TEB Chair also noted that:

[a]dditional time may have provided an opportunity to have greater assurance with regard to Returns on investment for the use for Commercial purposes; however this has been mitigated by the inclusion of SME [subject matter expert] audits and the CIEP [Continuous Improvement and Efficiency plan].¹⁴⁴

Recommendation no. 6

3.112 The Department of Defence ensure, for complex procurements, that there is traceability between request for tender (RFT) requirements, the risks and issues identified during the tender assessment process, and the negotiated outcomes.

Department of Defence response: Agreed.

3.113 *Defence notes that the Defence Commercial Framework including Tender Evaluation, Contract Negotiation Directives and Contract Negotiation Report templates currently supports Defence officials undertaking complex procurements, which support traceability between RFT requirements, the risks and issues identified during the tender assessment process, and the negotiated outcomes.*

3.114 *Defence will strengthen this guidance in the Complex Procurement Guide to support traceability between RFT requirements, the risks and issues identified.*

Consideration by Defence Finance and Resourcing Committee

3.115 The negotiated outcome was endorsed, for IC consideration, by Defence’s Finance and Resourcing Committee (DFRC) on 26 February 2020.

3.116 The paper presented to the DFRC stated that the DMMA activity had:

identified Thales Australia as the only company demonstrating expertise in the conduct of operations and maintenance of munitions and explosives factories of this type and scale (classified as major hazard facilities) in Australia.

3.117 The paper also stated that the value for money assessment for the agreed contract had been ‘referenced to internal Defence benchmarks and strategic objectives, balanced against risks to the Commonwealth, to ensure that the benefits of SDMM are commensurate with the costs.’ The paper further stated that value for money was achieved, including through the following.

- Benchmarking of overall facilities operation against the extant SMIC arrangement.
- Comparing cost of products against alternate suppliers.¹⁴⁵

144 With the delegate’s approval, the requirement for a specific value for the initial CIEP was replaced by a forward planning schedule that reduces the Facilities Operating Cost to a mutually agreed level, which is to be monitored by the Contract Steering Committee. The delegate directed that any negotiated financial position should be ‘no worse than the current position’.

145 Taking into consideration the benefit of domestic manufacturing, factoring transport and storage costs for imported products, whilst considering the benefits of increased just in time manufacture.

- Reduction of the original tendered price across the term of the contract by \$160.3 million.
- Defence having the right to test the market for any new product not covered by the SDMM contract and for any capital works or asset replacement.
- Establishment of a more commercially focussed relationship and enhanced focus on capability management support by Thales as a strategic partner.
- Independent investigation of production and non-production areas of the facilities to ensure they are operating efficiently and reflect industry best practice.
- Review of costs to ensure Defence was not subsidising Thales' commercial operations.
- A greater range of contractual levers including on-going base cost reviews and the ability to adjust production to best suit Defence's evolving requirements.
- Multi-tenancy arrangements to build collaboration, ensure ongoing commercial tension, bring new technology and intellectual property to domestic munition manufacturing, enable a concentration of industry expertise, and optimise use of the facilities.

3.118 The paper outlined risks relating to: arrangement support costs, including asset replacement¹⁴⁶; multi-tenancy arrangements; contingent liabilities¹⁴⁷; Defence not choosing to source explosive ordnance from the facilities; available budget for the activities; and APS workforce resourcing.¹⁴⁸ The paper also included a comparison of the 2015 interim contract against Thales' tender response and the stage one and two negotiated outcomes. A comparison against the Defence positions in the RFT was not provided to the DFRC.

3.119 The DFRC noted the following.

- It was proposed that Defence enter into the SDMM contract with Thales at an agreed cost of \$1.146 billion over ten years, with the option of contract extensions based on successful performance and Defence delegate approval, up to an additional five years.
- The Mulwala and Benalla munitions factory capability had a total cost of \$1.327 billion over ten years, including \$921 million for facilities and operations maintenance payments, \$225 million for minimum ADF munitions orders, and \$181 million in support costs.
- The negotiated Minimum Order Value for purchase of munitions would be funded from the existing Army and Air Force sustainment budgets.
- The responsible area in Defence's Joint Capabilities Group had an existing budget of \$983 million over ten years, resulting in a \$118 million shortfall for non-munitions costs.

146 The paper advised on a risk that the asset replacement program (part of the \$181 million arrangement support costs) was insufficiently funded. This risk was considered to be partly mitigated by the approved Mulwala Decommissioning and Demolition project, funded for a total \$47.3 million from 2020–21 and the planned Defence Mulwala Benalla Facility Redevelopment project then budgeted for \$218 million for five years from 2022–23.

147 The paper stated that a legacy agreement between Defence and Thales under the SMIC arrangement imposed a financial liability covering redundancies of Thales staff originally employed by Australian Defence Industries and financial liabilities relating to four asset investments made by Thales at 30 June 2020.

148 The paper stated that the SDMM was a more complex arrangement, involving an increased role for Defence driving capability outcomes, new processes and managing a second tenant at the Benalla facility and consequently would entail higher overheads associated with governance and stakeholder engagement. The paper also stated that a workforce analysis had been commissioned, which was due to report in June 2020, to determine the size, structure and skill sets of the workforce required to manage the arrangements.

3.120 The paper to the DFRC had advised that Thales' tender response had proposed 45.6 per cent profit at risk for the facilities operation payment and munitions order value components of the contract price (see Table 1.2) and Defence had negotiated this up to 60 per cent profit at risk.¹⁴⁹ ANAO analysis of the method to calculate earned at risk profit in the agreed contract indicated that under the agreed contract, 51 per cent rather than 60 per cent of profit for the facilities operation payment component was at risk. This was due to caps in the contributory elements used to calculate Thales' scores against one of three key performance indicators (KPIs).¹⁵⁰

3.121 In response to the ANAO in April 2024, Defence confirmed that 51 per cent rather than 60 per cent was correct and noted that 'there is a calculation error of one element of KPI3'.

Consideration by Defence Investment Committee

3.122 Chief of Joint Capabilities presented to the IC on 18 March 2020, seeking agreement to recommend government approval for the funding and implementation of the Mulwala and Benalla capability and entering into the SDMM contract.

3.123 The sponsor's paper to IC included the same information presented to the DFRC on the decision to sole source to Thales and the DMMA process. Advice on value for money and key risks was also the same.

3.124 The paper presented to IC recommended that it: note that the DFRC had considered the Defence munitions arrangement and resource implications, out of session, in February 2020; agree to seek government approval for the funding and implementation of the Mulwala and Benalla Munitions Factory Capability at a total cost of \$1.327 billion over ten years¹⁵¹; and agree that Defence prepare advice to the Minister for Defence seeking approval for Defence to enter into the SDMM contract with Thales by 1 July 2020, at a cost of \$1.146 billion over ten years, and the minister's agreement to seek the Minister for Finance's approval of the commitment of funding. The IC agreed to the recommendations and requested that Joint Capabilities Group review the funding pressure points and provide an update to IC in 2022–23.

Approval by the Ministers for Defence and Finance

3.125 In April 2020, Defence recommended that the Minister for Defence approve funding of \$1.327 billion over ten years for the munitions factory capability, including \$1.146 billion in contract funding for an initial term of ten years; and implementation of the munitions factory capability and a new performance-based contract. The advice also recommended that the minister note that the 2015 interim contract would expire in June 2020; that Defence undertook a sole source

149 Defence's evaluation of Thales' tender response against the performance management framework component of the draft contract had noted that profit at risk as proposed by Thales (45.6 per cent) reduced the profit at risk 'to a level that is deemed insignificant.' During the evaluation, Defence's Performance Based Contracting Centre of Excellence had noted that: 'The Commonwealth's position on At Risk amount is 100% of profit on all Performance Based Contracts.' Defence advised in June 2024 that 'Reducing below this threshold is not uncommon and subject to negotiation outcomes on case by case procurements'.

150 The methodologies for calculating these KPIs were collaboratively developed by Defence and Thales during stage two of the contract negotiations. The caps in the contributory elements were developed by Thales and there is no evidence that Defence queried these caps.

151 The funding profile included: \$921 million for facilities and operations maintenance payments; \$225 million for minimum ADF munitions orders (sub-total \$1.146 billion); and \$181 million for capital works reinvestment, multi tenancy management and project office costs to support the arrangement.

procurement process with Thales to establish a new contract; and that the proposed contract was for an initial ten year term commencing 1 July 2020, with a maximum term of 15 years.

3.126 The advice to the Minister for Defence included substantially similar information on value for money to that provided to the DFRC and IC (discussed in the paragraphs 3.116 and 3.123), which included an emphasis on how profit at risk under the contract would incentivise satisfactory performance. As discussed in paragraph 3.120, while Defence had advised the DFRC that 60 per cent of Thales' facilities operation payment profit would be at risk against the agreed KPIs, 51 per cent was at risk under the contract. Profit at risk was a key element of the value for money assessment in Defence's advice to ministers and Defence senior leadership.

3.127 In its April 2020 advice, Defence also recommended that the Minister for Defence sign a letter seeking approval from the Minister for Finance. The minister agreed to Defence's recommendations and signed the letter to the Minister for Finance. The Minister for Finance responded on 27 May 2020, agreeing to the commitment of \$1.146 billion (Pre-Expenditure Review Committee 2020–21 out turned price and exchange) for a ten-year contract with Thales from 2020–21 to 2029–30, to be met from within Defence's existing resources.

Section 23 commitment approval by Defence

3.128 Approval for the commitment and expenditure of up to \$1.262 billion (GST inclusive) for the SDMM contract was signed by FAS Joint Systems on 16 June 2020, pursuant to section 23 of the *Public Governance, Performance and Accountability Act 2013* (PGPA Act).

3.129 The minute seeking approval noted that a shortfall of \$118 million would be managed within the extant Joint Capabilities Group budget in the first four years (around \$24 million) and managed as a funding pressure from year five onwards (around \$94 million). The minute also included advice regarding: value for money; the Contract Negotiation and Source Evaluation Reports; endorsement by the Ministers for Defence and Finance; and legal, probity and financial matters.

3.130 The delegate was provided the same advice as the DRFC, IC and ministers on achievement of value for money through the negotiated head contract.

3.131 The delegate was also advised, in relation to the value for money of the facilities operation payment element of the contract price, that: Thales had guaranteed a minimum offset of the facilities operation payment, based on the value of ADF and commercial sales; Thales was programming an additional offset based on programmed ADF orders; Thales had agreed to an 'Activity Provision and Usage Allowance' offset; there would be prior awareness and approval by Defence of how Thales utilised budgeted contingency in the facilities operation payment; and Thales would undertake and had included in the facilities operation payment costs for all works up to a specified amount

3.132 In relation to product price, Defence advised the delegate that relevant value for money considerations included: government direction for making munitions in Australia, surety of supply, surge capacity and greater self-sufficiency in time of conflict, the 'sunk cost' associated with operation of the facilities, that the agreed contract ensured that ADF requirements would be

considered in determining the volume and nature of commercial products manufactured¹⁵², and that the value of product ordered from the facilities contributed to a return on Defence's facilities operations payments, reducing the operational cost burden.

3.133 The delegate was also advised that:

The recently approved Sovereign Industrial Capability Priority (SICP) for munitions and small arms implementation plan approved by Minister of Defence Industry ... requires Defence to prioritise domestic manufacturing. As such whilst domestic manufacturing includes a premium for higher cost base and lower volumetric, there is an implied obligation on Defence to pursue [sic] such, compared to overseas options which may in some case be cheaper but not meet Government policy.

3.134 The SDMM contract was signed on behalf of the Commonwealth by FAS Joint Systems on 24 June 2020. The Australian Government announced on 29 June 2020 that Defence had signed a new 10-year agreement valued at \$1.2 billion with Thales for the continued management and operation of the facilities.

152 The minute stated that these elements of the contract were intended: 'to align manufacturing capabilities to support a 'just in time' capability for ADF needs', with a view to achieving 'less storage of product for "just in case" contingency stocks and surety of supply for operations (capacity beyond training demand)'.

4. Probity management

Areas examined

This chapter examines the Department of Defence's (Defence) management of probity during the process to establish the Strategic Domestic Munitions Manufacturing (SDMM) contract.

Conclusion

Defence did not establish appropriate probity arrangements in a timely manner. A procurement-specific probity framework to manage risks associated with the high level of interaction between Defence and Thales was not put in place until July 2018. Probity risks arose and were realised during 2016 and 2017, including when a Defence official solicited a bottle of champagne from a Thales representative. Defence did not maintain records relating to probity management and could not demonstrate that required briefings on probity and other legal requirements were delivered.

Area for improvement

The ANAO made two recommendations aimed at improving Defence's management of engagement probity risks in complex procurements involving high levels of tenderer interaction.

4.1 Paragraph 6.6 of the 2018 *Commonwealth Procurement Rules* (CPRs) established the high level expectations regarding probity management in Commonwealth procurement, stating that:

In particular, *officials* undertaking *procurement* **must** act ethically throughout the *procurement*. Ethical behaviour includes:

- a. recognising and dealing with actual, potential and perceived conflicts of interest;
- b. dealing with *potential suppliers*, *tenderers* and *suppliers* equitably, including by
 - i. seeking appropriate internal or external advice when probity issues arise, and
 - ii. not accepting inappropriate gifts or hospitality;
- c. carefully considering the use of *public resources*; and
- d. complying with all directions, including *relevant entity* requirements, in relation to gifts or hospitality, the Australian Privacy Principles of the *Privacy Act 1988* and the security provisions of the *Crimes Act 1914*. [emphasis in original]¹⁵³

4.2 In addition, Defence's procurement framework established specific probity management requirements to be observed by Defence personnel.

Were appropriate probity arrangements established in a timely manner?

Defence did not establish appropriate probity arrangements in a timely manner. Defence did not have project and procurement-specific probity arrangements in place until July 2018, more than two years after its initial engagement with Thales (in March 2016) about future domestic munitions manufacturing arrangements. Prior to establishing these probity arrangements, Defence did not assess or take steps to manage potential probity risks arising from ongoing

¹⁵³ The 2018 CPRs commenced on 1 January 2018.

direct engagement with the incumbent operator or remind those involved of their probity obligations, including in relation to offers of gifts and hospitality. During this period, these probity risks were realised and there was evidence of unethical conduct, including when a Defence official solicited a bottle of champagne from a Thales representative.

While Defence's Complex Procurement Guide identified 'inherent' probity risks in 'any procurement that involves high levels of tenderer interaction' Defence did not appoint a probity adviser external to Defence. Defence maintained a register of probity documentation but did not retain relevant records for one of the 65 personnel recorded as having completed documentation. For 22 (25 per cent) of the 87 personnel who completed probity documentation, this completion was not recorded in any register. There was no relevant probity documentation for a further six individuals involved for a period in the procurement. Defence's conflict of interest (COI) register for the procurement was also incomplete. It did not record six instances where a Defence official or contractor declared a potential, perceived or actual COI, including a Tender Evaluation Board member's declaration of long-term social relationships with Thales staff. Defence was unable to provide evidence that briefings on probity and other legal requirements were delivered in accordance with the Legal Process and Probity Plan for the procurement.

Probity arrangements and issues before mid-2018

4.3 While planning activities for the procurement had commenced by March 2016, Defence did not implement project or procurement specific probity arrangements until July 2018, over two years later. As discussed in paragraphs 3.59 to 3.60, Defence's Complex Procurement Guide (CPG) identified 'inherent' probity risks in 'any procurement that involves high levels of tenderer interaction'. Engagement risks of the type identified in the CPG arose in the period before mid-2018.

4.4 Senior Defence personnel made representations at an October 2016 summit meeting with Thales that could be perceived as committing Defence and government to a particular course of action that had not been officially endorsed or approved prior to the Defence Investment Committee's (IC) approval in December 2016 (see paragraph 2.59). The summit minutes stated that:

HJS [Head Joint Systems] acknowledged the various options for consideration for the ownership and operation of the factories, and taking into account MHF [Major Hazard Facilities] licensing complications, along with Thales competence demonstrated over previous commercial arrangements, that Defence's preference would be to progress a Government Owned Contractor Operated (GOCO-T) arrangement with Thales into the future.¹⁵⁴

4.5 In a November 2016 email exchange, a Defence official sought assistance from, and provided information to, Thales on: the development of internal advice to the IC; Defence committee processes; and internal Defence thinking and positioning.¹⁵⁵

4.6 Defence records indicate that in May 2017, this Defence official also solicited a bottle of champagne from a Thales representative. In a response on the same day, the Thales representative acknowledged that they had previously offered the gift to the Defence official. The email exchange indicated that the initial offer had been conditional on the Mulwala Redevelopment Project being

154 See paragraphs 2.48 to 2.49 of this audit report.

155 See paragraphs 2.49 to 2.51.

removed from the Projects of Concern list. The initial offer of a gift was not recorded in Defence's gifts and benefits register. Both email exchanges evidenced unethical conduct. The Defence official subsequently commenced employment with Thales Australia (Australian Munitions) in April 2019.

4.7 The exchange relating to the solicitation of a gift was copied to two other persons, the one-star military officer supervisor of the Defence official and another Thales representative.¹⁵⁶ There is no evidence of the supervisor taking any action following receipt of the email, such as initiating review or disciplinary action.

4.8 As discussed in paragraph 2.51, a procurement-specific probity framework was not put in place until July 2018, to manage engagement probity risk in the context of pursuing a strategic partnership arrangement with Thales. By that stage, some of these probity risks had already crystallised during 2016 and 2017.

4.9 In light of these probity issues and the long-term nature of the SDMM contract, there would be merit in Defence considering how to address the engagement risks associated with the close professional relationships that may arise in the context of the strategic partnership construct it has adopted for this and other contracts.¹⁵⁷

Recommendation no. 7

4.10 The Department of Defence develop procurement-specific probity advice for complex procurements at the time that procurement planning begins, and develop probity guidance for:

- complex procurements involving high levels of tenderer interaction; and
- managing engagement risks in the context of long-term strategic partnership arrangements.

Department of Defence response: *Agreed.*

4.11 *Since the period of the audit, the Defence Procurement Manual (DPM) has been amended to provide additional context on Conflicts of Interest within the planning stage of the procurement.*

4.12 *Defence has a range of policy and guidance documents relating to probity including Integrity Policy Manual and Probity Toolkit. Defence will enhance guidance within the Probity Toolkit to enable probity advisors to develop procurement-specific probity advice relating to complex procurements involving high levels of tenderer interaction; and engagement risks in the context of establishing long-term strategic partnership arrangements.*

Probity planning from mid-2018

4.13 Defence's CPG listed five plans to be developed as a section within or an attachment to the procurement plan (or strategy) during the planning phase. It was open to Defence procurement personnel to adapt these components according to the scope, scale and risk of the procurement.

¹⁵⁶ The Thales representative was a party to the November 2016 email exchange discussed in paragraphs 2.50 and 4.5 of this audit report.

¹⁵⁷ For example, strategic industry partnerships feature in the *Defence Industry Development Strategy* announced by the Australian Government on 29 February 2024. The strategy is available from <https://www.defence.gov.au/about/strategic-planning/defence-industry-development-strategy> [accessed 28 March 2024].

4.14 Two of these plans — the industry engagement plan and probity plan — were interrelated and together set out the ‘proposed activities that would be undertaken to engage industry early and then throughout the procurement life cycle’.¹⁵⁸ The guide noted that each stage of the procurement life cycle requires specific industry engagement and related probity issues to be considered.

4.15 An ‘SDMM Communications Plan’, covering all communication and stakeholder engagement during the procurement process, and an ‘SDMM Legal Process and Probity Plan’ were both approved by the Director-General Explosive Materiel on 16 July 2018. The communications plan was updated to incorporate multi-tenancy arrangements between June and July 2019. Defence records do not document whether this version was approved. An updated version of the probity plan addressing the multi-tenancy arrangements was approved on 20 August 2018.¹⁵⁹

SDMM Communications Plan

4.16 The communications plan’s objectives included: ensuring that probity principles outlined in the Legal Process and Probity Plan were maintained; and ensuring that Defence senior leaders were appropriately informed of progress. It also outlined the following record keeping requirements to support those objectives.

- All key documents and communications must be kept within the electronic records management system (Objective), in accordance with Defence record-keeping policy.¹⁶⁰
- Noting that ‘a range of face-to-face meetings with stakeholders, particularly Thales and other munitions companies’ would be held, records were to be created for all meetings, including agendas, decisions taken, outcomes reached and any agreed actions, and filed in Objective (Defence’s record keeping system).
- Written records of telephone or informal communications would ‘be made as necessary to provide an appropriate audit trail, and those records must be held in Objective’.¹⁶¹

SDMM Legal Process and Probity Plan

4.17 The Legal Process and Probity Plan set out the probity and ethical principles and procedures to be followed during the procurement. It also set out the following.

- Legislative and regulatory requirements and the responsibilities of the probity adviser.

158 The three other plans, or sections, were: a risk management plan (see paragraph 3.11 of this audit); procurement schedule (see paragraph 3.10 of this audit); and a resource plan.

159 This version was substantially similar to the July 2018 plan, with the exception of procedures requiring completion of updated probity documentation if the plan was updated. The plan allowed those who had previously completed these documents to confirm in writing to the Procurement Manager that: they had been briefed on and provided a copy of the updated plan and understood the updates and implications; there was no change necessary to their declaration; and they acknowledged the continued application, where applicable, of the non-disclosure agreement.

160 ‘Key documents and communications’ were defined as including ‘draft and final contracts and agreements, contractual deliverables, and all types of formal correspondence, particularly those recording or transmitting a decision’.

161 The plan also noted that ‘[t]elephone conversations or other informal means of communication can result in directions or decisions.’

- Procedures for identification and management of conflicts of interest, including instructions for managing offers of gifts and hospitality, offers of employment, and communication with providers or potential providers.
- All personnel involved in the procurement were required to complete a conflict of interest declaration. Defence contractors were also required to complete a non-disclosure agreement.
- Records management arrangements for managing confidential information.

4.18 Under the plan, Defence's Director Munitions Industrial Base had responsibility for ensuring awareness of the plan and was assigned other responsibilities as the Procurement Manager. Defence's implementation of these requirements is discussed in paragraphs 4.31 to 4.50.

4.19 The plan stated that an individual would be nominated by Materiel Procurement Branch (MPB) as the probity adviser on the first occasion probity advice was required. This officer was to remain the probity adviser unless circumstances required that a replacement be nominated. The SDMM Tender Evaluation Plan (TEP) identified a Defence official from Defence Legal, then part of Defence's Associate Secretary Group, as the Lead Probity Advisor.¹⁶²

4.20 In May 2024, Defence advised the ANAO that '[t]he Complex Procurement Guide defines an external probity adviser as an adviser who is external to the department and an independent probity adviser as an adviser who is external to the project.' When the Legal Process and Probity Plan was approved in July 2018, the CPG provided the following guidance on when to engage external probity advisers.

For procurements that are assessed to have high probity risks, additional measures may be required, for example, the appointment of an independent external legal process or probity adviser, and the development and approval of a dedicated probity plan (this is discussed further in Chapter 2 of the Guide). Procurements with high probity risks are typically those that are very high in value and often with significant political or industrial sensitivity, or where there may be high levels of interactive engagement with industry during the process (and hence greater risk of perceptions or allegations of unequal treatment between tenderers).

4.21 As discussed in paragraphs 3.59 to 3.60, Defence's CPG also outlined that the engagement process and activities for procurements involving high levels of tenderer interaction 'should be planned and conducted with appropriate specialist support'.¹⁶³ Examples included procurements involving 'interactive clarification workshops during tender evaluations' or 'comprehensive ODIA [offer definition and improvement activities]' processes. The CPG further advised that:

For procurements with a high level of high industry engagement and probity risk, an external legal process or probity adviser, independent of the external legal adviser, will normally be engaged by Defence to provide guidance and advice on legal process and probity issues. This is to ensure that there can be no actual or perceived conflict between the probity and legal roles that could compromise the duty of the probity adviser to give candid advice.

162 An internal Defence email in September 2019 outlined that Defence Legal's role was intended to be on an 'ad-hoc and as required basis', with advice from Defence Legal to be sought through Defence's Materiel Procurement Branch (MPB) '[u]nless an urgent issue has arisen and MPB are not available'.

163 As discussed in paragraph 3.72 in April 2019 MPB had also provided advice on the management of engagement risk, to Defence personnel involved in the procurement. The advice emphasised the importance of being 'cognisant of probity issues' in communications with Thales.

4.22 On the other hand, advice in the CPG and the Defence Procurement Policy Manual (DPPM) in place at the same point in time, was that there were no circumstances in which engaging external advice was mandatory. Specifically, the DPPM stated that:

there is no requirement for Defence officials to engage an external probity or process adviser, or that they be independent of another adviser (for example, the legal adviser). Depending on the nature of the procurement, internal personnel (for example, contracting officers or Defence Legal officers) can potentially perform the role of a probity adviser for a Defence procurement.

...

The decision about whether to have an independent probity or legal process adviser should be made based on the individual circumstances of the case, and in particular, whether the procurement is likely to be high profile, high value, controversial or sensitive.¹⁶⁴

4.23 Similarly, the CPG further stated that:

In deciding whether to engage an external probity practitioner, Defence officials should weigh up the benefits of receiving independent advice against the additional cost and any delay it might cause. Consideration should also be given to the procurement risks and whether or not skills exist within Defence to fulfil the role.

4.24 Defence's approach for the SDMM differed to the approach it took for the previous Domestic Munitions Manufacturing Arrangements (DMMA) procurement in 2012, where a legal firm (Ashurst, then Blake Dawson Waldron) had been engaged as the Legal Process Adviser.¹⁶⁵ The SDMM procurement had the high risk characteristics described in the CPG and DPPM (see paragraphs 4.20 to 4.23), including high value, industrial sensitivity¹⁶⁶, and high levels of interactive engagement with industry in the context of a sole source process. Defence did not appoint a probity adviser external to the department as anticipated by the CPG for a high-risk procurement with 'inherent' probity risks.¹⁶⁷

164 The DPPM additionally set out the following guidance.

The main reason to have a 'legal process adviser' as opposed to a 'probity adviser' is to maintain legal professional privilege in relation to the 'probity' advice. Non-lawyers cannot provide legal advice, so no legal professional privilege would apply to their advice if there is a challenge to the procurement process. Advice from a lawyer in relation to probity/process would be covered by the same rules as other legal advice.

165 The scope of this engagement included providing probity advice, attending industry briefings and other meetings, and reviewing correspondence between Defence and Thales or other potential tenderers. Ashurst continued to be engaged, following suspension of the DMMA process, to review and develop process documents, probity guidance, and request for tender documentation for the interim contract procurement process. This included supporting Defence to identify and manage risks to the DMMA process, should government decide to recommence that activity, including providing a briefing to Defence personnel on probity risks related to the interim contract and maintaining the ability to recommence the activity.

166 See footnote 104.

167 Defence's records indicate that the appointment of an external probity adviser was considered by the contracted Deputy Project Manager and a secondee to MPB in the context of drafting the Legal Process and Probity Plan.

Recommendation no. 8

4.25 The Department of Defence make appointment of external probity advisers mandatory for all complex procurements with high probity risks such as procurements with high levels of tenderer interaction.

Department of Defence response: *Agreed.*

4.26 *Defence agrees to make the appointment of external probity advisors (including probity advisers who are external from the Group or Division undertaking the procurement) mandatory for all complex procurements with high probity risks, such as procurements with high levels of tenderer interaction.*

4.27 *Defence notes that the current Complex Procurement Guide provides guidance to officials on when to appoint and engage an independent probity adviser dependent upon the scope, scale and sensitivity of the procurement.*

4.28 *Defence will update the Defence Procurement Manual to ensure that an external probity adviser (including probity advisers who are external from the Group or Division undertaking the procurement) is engaged for any complex procurements with a high probity risk, such as procurements with high levels of tenderer interaction.*

ANAO comment

4.29 As outlined at paragraph 4.24, Defence did not engage a probity adviser external to the department for the SDMM procurement, as it had done for the previous 2012 process, or as anticipated by its CPG for high-risk procurements with high levels of tenderer interaction. The relevant sections of Defence's internal guidance on the appointment of external probity and legal process advisers are discussed from paragraphs 4.20 to 4.23.

4.30 For the purpose of this recommendation, Defence has indicated at paragraph 4.26 that it considers 'external probity advisors' to include 'probity advisers who are external from the Group or Division undertaking the procurement'. This is not consistent with Defence's May 2024 advice to the ANAO on external probity advisers (see paragraph 4.20), or the intent of this recommendation, which was that probity advisers external to the department be appointed for all complex procurements with high probity risks such as procurements with high levels of tenderer interaction.

Probity registers

4.31 Defence established two probity registers. These were a documentation completion tracker and a conflict of interest (COI) register.

Documentation completion tracker

4.32 Defence's probity documentation completion tracker contained 70 entries dated between 26 June 2018 and 13 January 2020. For the 70 entries, Defence records indicated the following.

- A COI declaration was completed by 64 personnel, consisting of Defence personnel and contractors. Of these 64 personnel:

- 22 completed both the Legal Process and Probity Plan declaration and the tender evaluation plan declaration¹⁶⁸;
 - 19 completed only the Legal Process and Probity plan declaration; and
 - 23 completed only the tender evaluation plan declaration.
- One person was recorded as having completed a declaration where Defence had not retained the relevant record. This person had infrequently acted as Director-General Explosive Materiel.
 - Five personnel had not completed a COI declaration, of which four were recorded as a 'near neighbour of SDMM team' and one as being on leave during the tender evaluation.

4.33 The ANAO identified 29 personnel involved in the SDMM process who were not recorded in the tracker. For these 29 personnel, Defence records indicated the following.

- Twenty-two had completed a COI declaration and/or non-disclosure agreement or deed of confidentiality.¹⁶⁹
- Three were members of Defence's senior leadership group who were responsible for Defence's management of the facilities at the Senior Executive Service Band 1, 2 and 3 level or their military officer equivalents during the procurement, for whom there was no evidence of completed probity documentation.¹⁷⁰
- One was a Defence official who was a product subject matter expert performing the role of Expert Adviser, for whom there was no evidence of completed probity documentation.
- One was a probity adviser from the Australian Government Solicitor on a secondment in Defence Legal, who was listed in the TEP as a probity expert, for whom there was no evidence of completed probity documentation.
- One was the PGPA section 23 delegate (FAS Joint Systems), for whom there was no evidence of completed project or procurement-specific probity documentation.

168 Declaration templates were included in the TEP (see paragraph 3.54) and the Legal Process and Probity Plan (see paragraph 4.17). The TEP declaration was narrower in scope. Members of the Tender Evaluation Organisation were required to complete both declarations.

169 These individuals included the Commander and Deputy Commander Joint Logistics and other personnel from Joint Capabilities Group, for whom Defence records indicated that this documentation had been completed but stored in a location in Defence's records management system separate from the other procurement records.

170 These three individuals, who occupied the roles of Deputy Secretary CASG, Head Joint Systems and Director-General Explosive Materiel during the relevant period, were required by Defence's internal policies to make written declarations of their 'private interests and relationships that could impact or be seen to impact upon the decision they are making or the advice they are giving because of an actual or potential conflict of interest.' No such written declarations had been filed for these individuals for the period in which the facilities were within the ambit of their responsibilities. From April 2017 to June 2021, the DPPM stated the following regarding senior Defence officials who had regular access to sensitive procurement information.

There are some senior Defence officials who will have regular access to sensitive information related to Defence procurements, in particular the members of the Defence Committee, Investment Committee and Enterprise Business Committee. In addition, Defence's Contestability organisation may also be required to have access to this information to perform its function. As part of Defence's probity framework, members of these Committees and the Contestability organisation acknowledge under their respective business rules the legislative and policy obligations that apply in relation to confidential information and conflicts of interests. Accordingly, these Defence officials are not required to receive procurement specific probity briefings or sign individual probity statements.

- One was the Deputy Secretary CASG, who as a member of the IC was not required to complete project or procurement-specific probity documentation (see footnote 170).

Conflict of interest register

4.34 Defence's COI register contained two entries. The ANAO's review of available COI declarations identified six more instances where a Defence official or contractor declared a potential, perceived or actual COI, indicating that the COI register was incomplete.

4.35 The eight instances where a Defence official or contractor declared a potential, perceived or actual COI occurred between August 2018 and February 2020.

- Two contractors from KPMG declared that KPMG provided professional services to Thales. A mitigation plan to manage the identified risk was not developed.
- One Defence official declared a friendship with a Thales employee following a dinner with a friend who worked for Thales. This was recorded in the COI register with a mitigation plan.
- One Defence official, listed in the TEP as a work health and safety expert adviser, declared previous employment by Thales from July 2009 to January 2016. They held 50 Thales shares and received dividends from these. There was no mitigation plan.
- One Defence official declared 'numerous associations with a number of entities that may work with Defence or the Commonwealth.' There was no mitigation plan.
- One Defence official, the Director-General Explosive Ordnance, who was a member of the Tender Evaluation Board, declared long-term social relationships with NIOA, Thales Australia and Australian Munitions staff.¹⁷¹ There was no mitigation plan.

4.36 The ANAO identified three more instances where potential, perceived or actual COIs were declared via email but were not recorded in a COI declaration or the COI register.

- One contractor from KPMG, the Commercial and Contracting TEWG Lead, declared that their daughter was to undertake an internship at Thales. There was no mitigation plan.
- One contractor from Scotwork Australia, one of Defence's contracted lead negotiators, declared that the firm was to provide negotiation training to Thales (this is discussed further in paragraphs 4.47 to 4.50).
- One Defence official declared that their fiancé worked for Thales, including previously working at Benalla, and had a company share package. The official was advised by the Deputy Project Manager to include these details in a COI declaration. A declaration was not subsequently completed and there was no mitigation plan.

4.37 In the context of a complex sole source procurement involving ongoing engagement with the incumbent operator, shortcomings in the reliability and completeness of Defence's COI register for the SDMM procurement introduced risk in Defence's management of probity.

171 This declaration was made under the Legal Process and Probity Plan, but the Defence official did not declare the conflict in the TEP COI declaration.

Gifts and hospitality

4.38 The CPRs provide that officials undertaking procurement must act ethically throughout the procurement, and that ethical behaviour includes not accepting inappropriate gifts or hospitality.¹⁷² The CPG similarly sets out that:

Defence officials are required to act with ‘probity’ when undertaking procurements. For most complex procurements, this means applying a standard probity framework for effectively engaging with industry, including clear documented procedures for managing tenderer engagement and communications, conflicts of interest, the offers of gifts and hospitality, probity briefings at appropriate stages during the process and the appointment of an internal probity manager or adviser to ensure continuity and consistency of probity advice during the process.¹⁷³

4.39 The SDMM Legal Process and Probity Plan stated the following.

The solicitation or acceptance of gifts or hospitality from any party that has a likely or potential interest or association with the procurement activities, including potential providers, is prohibited. Should personnel involved in the procurement activities consider that exceptional circumstances exist that warrant a variation to this blanket policy, they are to seek the written approval of First Assistant Secretary Joint Systems (FASJS) who will consider the request in accordance with DI(G) PERS [Defence Instructions (General) Personnel] 25-7 Gifts, Hospitality and Sponsorship. FASJS may also seek advice from the Probity Adviser if appropriate.

4.40 As discussed in paragraph 4.6, Defence records indicate that a Defence official failed to declare a gift offered by a Thales representative and subsequently solicited receipt of the gift from the Thales representative by email.

4.41 Defence records also indicate that following contract signature on 24 June 2020, four Defence officials attended a lunch paid for and attended by Thales Australia’s CEO.¹⁷⁴ The receipt of this hospitality, which was valued at approximately \$276 in total, was declared in Defence’s gifts and benefits register on 3 July 2020.

Probity briefings and advice

4.42 The SDMM Legal Process and Probity Plan stated that where necessary the probity adviser or a nominated representative would brief all personnel on their obligations under the plan and other legal requirements, with new personnel to be provided an additional briefing where necessary. Defence did not retain evidence that briefings were delivered by the probity adviser or a nominated representative on probity and other legal requirements in accordance with the plan.

4.43 The ANAO reviewed the probity advice retained in Defence records.¹⁷⁵ Two specific instances of probity advice given by the probity adviser are discussed below.

172 Department of Finance, *Commonwealth Procurement Rules*, 13 June 2023, paragraph 6.6. Comparable provisions have appeared in successive versions of the CPRs, including the January 2018 and July 2022 CPRs.

173 Comparable provisions have appeared in successive versions of the CPG since April 2017.

174 The Defence attendees included the Director-General Explosive Materiel, a Deputy Project Manager for the SDMM procurement, and a Defence official from Materiel Procurement Branch in CASG. Thales attendees included Thales Australia’s CEO and Vice President Land.

175 Probity directions and advice were also provided by a Deputy Project Manager for the SDMM Procurement, who had been designated as the ‘probity officer’ and had responsibility for managing probity, including maintaining the probity documentation and COI registers (see paragraphs 4.31–4.37).

Release of Thales' partial draft response before tender evaluation plan approval

4.44 On 16 September 2019, Thales sent the SDMM Project Manager an 'exposure draft' of part of Thales' tender response. The Project Manager subsequently forwarded this to two Tender Evaluation Working Groups (TEWG) members, one of whom opened and read the material. That recipient had completed the required COI declaration and non-disclosure agreement before doing so.

4.45 Advice from the probity adviser dated 17 November 2019 outlined that while there was no clear process for the treatment of 'exposure' information, such information should be treated as formal tender information. Further, the probity adviser strongly recommended that the TEP be signed off by the delegate immediately, to avoid 'the assumption that the amendment arose because of the information (which would bring the neutrality of the process into question ...)'.

4.46 The Director Munitions Industrial Base advised the probity adviser on the same day (17 November 2019) that the recipients of the material had been directed to delete Thales' 'exposure draft' response and the delegate planned to sign off the TEP the following day. The Director further advised that the TEP had been updated to incorporate the advice from the probity adviser on the treatment of exposure drafts as formal tender information. It was noted that other exposure draft information had been sent to Defence by Thales the previous week, with only one TEP secretariat officer seeing the emails (but not opening the attachments), and the information had been stored in a secure location only accessible by the TEP secretariat officer.

Provision of training to Thales by the firm engaged as Defence's lead negotiator

4.47 In October 2019, Defence engaged Scotwork Australia as the lead negotiator for the SDMM contract. On 15 September 2019, in response to a request from Defence, Scotwork Australia provided a quotation recommending that training be delivered to both Defence and Thales by the contracted lead negotiators for Defence. The quotation noted that the lead negotiators had 'delivered dozens of ANS [advanced negotiation skills] courses to Defence (and Thales) over the years.' Defence advised the ANAO in November 2023 that negotiation training, fully funded by Defence, 'was provided to both the Thales and the Commonwealth negotiation teams at the same time and location with no segregation.'

4.48 On 29 November 2019, one of the two lead negotiators declared via email a potential conflict of interest arising from Thales engaging Scotwork Australia to deliver a negotiation course (this was separate to the training discussed in paragraph 4.47). The lead negotiator advised Defence that together, the two negotiators held 55 per cent of the equity in Scotwork Australia and would benefit financially from the work. The lead negotiator further advised that: the negotiators were not involved in selling or delivering the course; the firm had strict ethical walls procedures in place; and the revenue was not material.

4.49 On 29 November 2019 the Deputy Project Manager sought advice from the probity adviser on the two lead negotiators' declaration. On the same day, the probity adviser advised that there was a 'potential for an actual or (more likely) perceived COI, based on the fact that Scotwork Australia (SA) is receiving a separate financial benefit from Thales for the training.' Defence accepted the mitigations proposed by the lead negotiators and did not enquire as to the dollar value of the revenue. The lead negotiators' COI declarations were not updated following the declaration concerning the training. There was no indication of the ongoing mature business relationship between the firm and Thales outlined in the quotation of 15 September 2019.

4.50 This situation gave rise to both a real and perceived conflict of interest. The two lead negotiators for the Commonwealth had an ongoing business relationship with Thales, as providers of contract negotiation training.

A handwritten signature in black ink, appearing to read 'Rona Mellor'. The signature is fluid and cursive, with a large loop at the start of the first name.

Rona Mellor PSM
Acting Auditor-General

Canberra ACT
25 June 2024

Appendices

Appendix 1 Entity response



Australian Government

Defence

PO Box 7900 CANBERRA BC ACT 2610

EC24-002520

Ms Rona Mellor, PSM
Acting Auditor-General
PO BOX 707
CANBERRA ACT 2601

Dear Ms Mellor

Auditor-General Proposed Report on Defence's management of contracts for the supply of munitions

Thank you for the opportunity to comment on the Proposed Report for the Auditor-General performance audit *Defence's management of contracts for the supply of munitions*.

We are committed to upholding the integrity of Defence and its people. Defence continues to instil a culture that supports probity and has strengthened its policies and practices around complex procurements and probity considerations.

We accept the findings and recommendations of the report. The identified issues are not evidence of the standard expected and we commit to their remediation through the continual education and training of staff. This includes an increased focus on the recording of decisions and compliance with Defence's record keeping policies.

Attached to this letter are Defence's proposed amendments, editorials and comments (**Annex A**), response to requests for information (**Annex B**), response to proposed recommendations (**Annex C**) and Defence's summary response (**Annex D**). These constitute Defence's formal response to the Auditor-General Proposed Report.

Our point of contact is the Australian National Audit Office Liaison Officer who can be contacted via email at: anao.lo@defence.gov.au.

Yours sincerely

Greg Moriarty, AO
Secretary

Angus J Campbell, AO, DSC
General
Chief of the Defence Force

4 June 2024

7 June 2024

Appendix 2 Improvements observed by the ANAO

1. The existence of independent external audit, and the accompanying potential for scrutiny improves performance. Improvements in administrative and management practices usually occur: in anticipation of ANAO audit activity; during an audit engagement; as interim findings are made; and/or after the audit has been completed and formal findings are communicated.
2. The Joint Committee of Public Accounts and Audit (JCPAA) has encouraged the ANAO to consider ways in which the ANAO could capture and describe some of these impacts. The ANAO's Corporate Plan states that the ANAO's annual performance statements will provide a narrative that will consider, amongst other matters, analysis of key improvements made by entities during a performance audit process based on information included in tabled performance audit reports.
3. Performance audits involve close engagement between the ANAO and the audited entity as well as other stakeholders involved in the program or activity being audited. Throughout the audit engagement, the ANAO outlines to the entity the preliminary audit findings, conclusions and potential audit recommendations. This ensures that final recommendations are appropriately targeted and encourages entities to take early remedial action on any identified matters during the course of an audit. Remedial actions entities may take during the audit include:
 - strengthening governance arrangements;
 - introducing or revising policies, strategies, guidelines or administrative processes; and
 - initiating reviews or investigations.
4. During the course of the audit the ANAO did not observe changes in Defence's arrangements for the facilities.

Appendix 3 Contractual arrangements for management and operation of Benalla and Mulwala facilities since 1998

Contract	Duration	Description	Value
Mulwala Agreement	1 July 1998 to 30 June 2015	Required ADI Limited to manufacture propellant and high explosives to be supplied to the Benalla facility and was accompanied by a lease for the Mulwala site between the Department of Defence (Defence) and ADI Limited. ^{ab}	\$480 million
Strategic Agreement for Munitions Supply (SAMS)	1 July 1998 to 30 June 2015	Required ADI Limited to maintain a capability at the Benalla facility to manufacture munitions for the Australian Defence Force (ADF) and supply munitions to the ADF as ordered by Defence. ^{ab}	\$1432 million
Strategic Munitions Interim Contract (SMIC, or 2015 interim contract)	1 July 2015 to 30 June 2020	Required Thales to transition the Mulwala and Benalla facilities from the <i>Mulwala Agreement</i> and the <i>SAMS</i> , integrate the redeveloped Mulwala facility, and transform the business and operations into a more self-sustaining, business-like operation, pending a government decision on the long-term future of the facilities, and supply munitions to the ADF as ordered by Defence.	\$535 million
Strategic Domestic Munitions Manufacturing contract (SDMM, or 2020 contract)	1 July 2020 to 30 June 2030	Comprised of leases between Defence and Thales for all of the Mulwala facility, part of the Benalla facility, and certain surrounding pastoral lands. It also requires Thales to operate, maintain and manage the facilities and supply munitions to the ADF as ordered by Defence.	\$1,369 million

Note a: ADI Limited was acquired by Transfield Holdings Limited and Thales Australia in November 1999 and the *Mulwala Agreement* and the *Strategic Agreement for Munitions Supply* were novated to the new owners. Since 1999, Thales has managed and operated the facilities at Benalla and Mulwala under several different contractual arrangements.

Note b: Product from Mulwala was supplied at cost to the Benalla Facility, which then included that cost in the total cost of munitions sold to Defence. Thales' management and operation of the facilities under the *Mulwala Agreement* and the *SAMS* was discussed in the previous Auditor-General reports outlined at paragraph 1.24.

Source: ANAO analysis.

Appendix 4 Timeline of Defence's procurement of the 2020–30 contract

SMIC	2016	Jan 2016	Feb 2016	Mar 2016	Apr 2016	May 2016	Jun 2016	Jul 2016	Aug 2016	Sep 2016	1 October 2016	Nov 2016	Dec 2016
			Minister for Defence advised long-term options for the sites to be analysed	Thales seeks Defence advice on long-term direction	Defence agree to Explosive Ordnance Summit with Thales		Issues paper developed for future management of Benalla and Mulwala	Sole source with Thales endorsed as preferred long-term option			Explosive Ordnance Summit with Thales	Investment Committee (IC) paper developed	IC approves sole sourcing to Thales for long-term contract
		Jan 2017	Feb 2017	Mar 2017	Apr 2017	May 2017	Jun 2017	Jul 2017	Aug 2017	Sep 2017	Oct 2017	Nov 2017	Dec 2017
				Thales advised of IC decision and next steps discussed		Minister for Defence Industry advised of IC decision; NIOA unsolicited proposal	Minister notes IC decision and intent to negotiate new contract with Thales			Thales advised of Minister's endorsement; NIOA updates proposal	NIOA and Chemring added to Munitions Manufacturing IPT		NIOA updates proposal
	2018	Jan 2018	Feb 2018	Mar 2018	Apr 2018	May 2018	Jun 2018	Jul 2018	Aug 2018	Sep 2018	Oct 2018	Nov 2018	Dec 2018
		Minister for Defence Industry advised of potential multi-tenancy options	Minister announces negotiations with Thales; SDMM Smart Buyer review	SDMM Smart Buyer review					SDMM collaborative contracting process commences; Endorsement to Proceed signed	Minister announces NIOA sublease at Benalla	Collaborative contracting workshops with Thales commence	Tripartite agreement for NIOA sub-lease at Benalla executed	NIOA sub-lease executed
SMIC to SDMM	2019	Jan 2019	Feb 2019	Mar 2019	Apr 2019	May 2019	Jun 2019	Jul 2019	Aug 2019	Sep 2019	Oct 2019	Nov 2019	Dec 2019
		Defence internal workshops on contracting model and multi-tenancy		Defence commences workshops with Thales/NIOA for NIOA direct lease				Multi-tenancy approach and objectives/success criteria approved	Revised Endorsement to Proceed; SDMM RFT released	Thales response to SDMM RFT received	Tender evaluation; Tender Evaluation Steering Group (TESG) meeting	SDMM tender evaluation; response clarification meetings with Thales	Source Evaluation Report signed; SDMM negotiations commence
SMIC to SDMM	2020	Jan 2020	Feb 2020	Mar 2020	Apr 2020	May 2020	Jun 2020	Jul 2020	Aug 2020	Sep 2020	Oct 2020	Nov 2020	Dec 2020
		SDMM contract negotiations	Negotiations outcome report approved; TESG meeting	Investment Committee approves seeking Ministerial approval for SDMM	Minister for Defence approval for SDMM contract sought	Minister for Defence approves SDMM; Minister for Finance approves SDMM	Delegate signs Section 23 Commitment Approval for SDMM	SDMM and MMA contracts commence					

Note: 'SMIC' stands for the 2015–20 Strategic Munitions Interim Contract (with Thales). 'SDMM' stands for the 2020–30 Strategic Domestic Munitions Manufacturing contract (with Thales). 'MMA' stands for the 2020–30 Munitions Manufacturing Arrangement (with NIOA).

Source: ANAO analysis.

Appendix 5 Guidance for managing unsolicited proposals

1. Box 1 sets out guidance for the management of unsolicited proposals by the Departments of Finance and Defence in effect when the Department of Defence (Defence) received NIOA's proposal in May 2017.

Box 1: Guidance for managing unsolicited proposals

The 1 March 2017 Commonwealth Procurement Rules (CPRs) did not differentiate between solicited and unsolicited proposals until the procurement method was considered, at which point they noted that a procurement above the relevant threshold could be conducted by limited tender for procurements made under exceptionally advantageous conditions that arose only in the very short term, such as from unsolicited innovative proposals.^a

Contemporaneous Department of Finance guidance on selling to government stated that:

The Department of Defence receives many 'unsolicited proposals' from industry due to its unique business requirements. These proposals may range from small, off-the-shelf supply items to more complex capability solutions. Defence has therefore established an Unsolicited Proposals Gateway to provide a single entry point for businesses and individuals to submit their proposals to Defence.^b

The 1 April 2017 Defence Procurement Policy Manual (DPPM) included four references to unsolicited proposals. The first three references discussed unsolicited innovative proposals in the context of making a decision to use the limited tender procurement method, but did not define what was meant by 'innovative' in this context. These paragraphs stated that:

The second main circumstance is for 'unsolicited innovative proposals' where the procurement can be categorised as having been made under 'exceptionally advantageous conditions that arise only in the very short term' and which is not 'routine procurement from regular suppliers' (paragraph 10.3c of the CPRs). Sometimes industry will have an innovative idea that offers real value to Defence, even though it is not something that Defence has identified as a current need or priority. Paragraph 10.3c of the CPRs offers a mechanism for encouraging industry to put forward these ideas and, if Defence considers the idea of benefit, to procure directly from the relevant company without having to openly test the market.

However, Defence companies may sometimes seek to use this mechanism as a way of pitching their goods or services to Government without having to compete for a contract. If Defence officials act on these proposals without testing the market, then it may be unfair to other suppliers of similar goods or services, as well as being difficult to demonstrate value for money. Accordingly, Defence officials need to be cautious when using this circumstance to justify undertaking a limited tender. It is difficult to give definitive guidance about the kind of proposals that will meet this circumstance, however, as a general rule, it would cover most proposals that are unique or otherwise not readily obtainable in the market place. By contrast, the circumstance should not be used where the proposal is effectively an advance proposal for a requirement that Defence has already identified for procurement in the market. Defence officials should seek specialist contracting or legal advice before accepting an unsolicited proposal.

While Defence business units should be open to receiving and considering unsolicited innovative proposals from industry, Defence has also put in place a formal mechanism to manage these kinds of proposals from industry. This is the Centre for Defence Industry Capability (CDIC) which hosts the Defence Innovation Portal, the primary gateway for companies seeking to submit

innovation proposals or ideas to the Defence Innovation Hub and Next Generation Technology Fund.

The final reference to unsolicited innovative proposals was on page 58 of the 2017 DPPM, which replicated CPR paragraph 10.3c. That paragraph provided that an entity must only conduct a procurement at or above the relevant procurement threshold through limited tender in specified circumstances, such as:

for procurements made under exceptionally advantageous conditions that arise only in the very short term, such as from unusual disposals, unsolicited innovative proposals, liquidation, bankruptcy, or receivership, and which are not routine procurement from regular suppliers ... [emphasis in original].

Defence advised the ANAO in March 2024 that 'NIOA submitted an unsolicited proposal, not an "unsolicited innovative proposal".'

Amended policy guidance

In 2021 the ANAO observed a lack of clarity in Defence guidance on the handling of unsolicited proposals received by Defence, and suggested that to improve clarity and transparency regarding their handling, there would be merit in Defence clarifying the procedures to be applied by officials.^c

Defence subsequently incorporated the following guidance into the Defence Procurement Manual, the successor to the DPPM since June 2022.

Unsolicited Proposals

An unsolicited proposal is a proposal for the provision of goods and/or services from industry that has not been solicited by Defence. This means that the proposal has not been formally requested by Defence via a procurement approach to market. Defence is under no obligation to review or accept any unsolicited proposals.

If Defence officials receive an unsolicited proposal, Defence officials should ensure there are appropriate probity mechanisms in place to manage the handling of the proposal and any subsequent procurement process that may be undertaken. To identify and manage a conflict of interest, Defence officials should refer to the Defence Instruction Administrative Policy (AG5 – Conflicts of Interest and Declarations of Interest) and the Integrity Policy Manual which relate to the consideration and documentation of conflicts of interest in the procurement process. Defence officials should also ensure there are processes in place to identify, analyse, allocate and treat risk in relation to the unsolicited proposal (refer to AAI [Accountable Authority Instruction] 1 – Managing Risk and Accountability for further instruction). In accepting these proposals Defence officials should note there may be reputational risks and a perception that an open and fair competitive process has not been undertaken. This may result in official complaint being lodged through the Defence Procurement Complaints Scheme (DPCS).

Where an unsolicited proposal is effectively an advance proposal for a requirement that Defence has already identified for procurement in the market, Defence officials should not consider the proposal and encourage industry to look out for opportunities on AusTender.

Taking into account the above considerations, a desktop review of the proposal should be undertaken to establish its merit, ensure it aligns with Defence objectives and assess if the unsolicited proposal can achieve a value for money outcome for products or services which contribute to Defence outcomes. Prior to undertaking a desktop review of an unsolicited

proposal, Defence officials should seek specialist contracting or legal advice and establish appropriate probity protocols and arrangements to govern the review of the unsolicited proposal, with reference to the Probity Toolkit.

Where a decision has been made to progress with an unsolicited proposal, officials must conduct the procurement in accordance with the Commonwealth Procurement Rules (CPRs) and comply with all applicable Defence procurement policies (refer AAI 2 – Spending Defence Money – Procurement and the Defence Procurement Manual for further instruction). Proceeding with an unsolicited proposal must not be undertaken to circumvent Commonwealth and Defence procurement policies and processes.

Unsolicited Innovative Proposals

Where Defence receives an unsolicited proposal from industry that is above the relevant procurement threshold and is considered an unsolicited innovative proposal, a limited tender may be considered in accordance with Paragraph 10.3c from the additional rules in Division 2 of the CPRs. To utilise this limited tender condition, the proposal must fulfil all of the requirements of CPR 10.3c. There are three main factors that must be met for this condition to be appropriate that the:

1. opportunity exists only in the short term;
2. goods and/or services are not (and cannot) be routine procurement from regular suppliers; and
3. proposal is unsolicited and innovative.

While Defence business units should be open to receiving and considering unsolicited innovative proposals from industry, Defence has also put in place a formal mechanism to manage these kinds of proposals from industry. The Defence Innovation Hub Portal is the primary gateway for companies seeking to submit innovation proposals or ideas to the Defence Innovation Hub. For further information about the Defence Innovation Hub, Defence officials should refer to Defence Innovation Hub website. Prospective suppliers of innovative proposals can also be directed to the to seek advice on how to engage with Defence [emphasis in original].

Note a: Department of Finance, Commonwealth Procurement Rules, 1 March 2017, paragraph 10.3, available from <https://www.legislation.gov.au/F2017L00136/asmade/text> [accessed 30 January 2024]. The 2017 CPRs applied between 1 March 2017 and 31 December 2017.

Note b: The Unsolicited Proposals Gateway referred to in the Department of Finance guidance was no longer available when the NIOA proposal was received by Defence.

Note c: Auditor-General Report No.15 2021–22 *Department of Defence's Procurement of Six Evolved Cape Class Patrol Boats*, paragraphs 2.6 to 2.12.