

Management of IT Outsourcing

Department of Veterans' Affairs

Performance Audit

Tabled 11 December 1996

Audit Report No. 21 1996-97

Abbreviations

ANAO Australian National Audit Office

CPU Central Processing Unit

DVA Department of Veterans' Affairs

IT Information Technology

NCC National Computer Centre

PEP Portfolio Evaluation Plan

SLA Service Level Agreement

Summary

The purpose of the audit

1. This report has been prepared following a review by the ANAO of the Department of Veterans' Affairs (DVA) management of an Information Technology (IT) outsourcing arrangement with a supplier for the provision of data centre services. The audit specifically addressed the management by DVA of the contractual arrangements. The timing of the audit took account of a request from DVA senior management for the ANAO to bring forward the conduct of a proposed audit in order to provide input to the current re-tender process addressing the future outsourcing requirements of DVA.

2. The proposal to outsource the National Computer Centre (NCC) was based on DVA's expected outcomes of:

- projected cost savings of the order of \$10-12 million over five years compared with maintaining an in-house facility;
- complying with the Government's 1991 Industry Statement which reaffirmed a commitment to outsourcing subject to cost effectiveness; and

- providing the most certain and flexible plan for DVA's future re-structuring while not precluding any decisions DVA may take in the future about transferring functions to other agencies.

Audit objective

3. The objective of the audit was to review DVA's management of the outsourcing of its data centre in Sydney from February 1992, specifically with respect to the management of its contractual arrangements. The audit sought to identify the extent to which DVA achieved its objectives of outsourcing and the effectiveness of its management of the arrangement with the supplier.

Audit criteria

4. The criteria used to assess the Department's performance included:

- the extent of DVA's own review of the outcomes of outsourcing and comparison to expectations;
- the incidence of disputes;
- the comparison of actual to projected costs;
- the effect on service delivery to users; and
- the effectiveness of the strategic and operational management of the outsourcing arrangement with the supplier.

Overall conclusion

5. The ANAO audit identified that actual costs were in line with the costs projected at the time the decision was taken to outsource. On the basis of the actual costs compared to the Department's original projections of the cost of continuing to operate the NCC in-house, the savings achieved have been in the order of the \$10m projected by DVA. The ANAO considers that this has been the result of a combination of factors including a stable work environment, a good relationship with the supplier and the resolution of operational issues at periodic meetings.

6. During the course of the audit DVA staff interviewed by the ANAO identified a number of benefits which flowed from the outsourced arrangement. Those most frequently referred to included improved communication through structured meetings, a greater focus on service delivery by data centre staff and generally a more professional attitude, a 24 hour operation with an uninterrupted power supply and no need for annual hardware upgrades as had been the case previously.

7. While the ANAO considers that DVA has been successful in outsourcing IT, a formal evaluation of IT outsourcing arrangements has not been undertaken by the Department to assess whether the expected outcomes have been achieved.

8. In addition, the ANAO found that the contract between DVA and the supplier was deficient in a number of areas.

9. Further, the ANAO considers that there was inadequate documentation of the management arrangements including the allocation of responsibilities for NCC activities between DVA and the supplier, the assignment of management tasks within DVA, resource planning and monitoring requirements and operational procedures.

10. For the next outsourcing arrangement DVA should make provision for a formal evaluation early in the life of the contract term, a contract that reflects the outsourcing experience gained from the current arrangement and adequate documentation of:

- responsibility boundaries with the supplier;
- the management structure within DVA;
- resource planning and monitoring requirements; and
- operational procedures

appropriate to the increased complexity of the new outsourcing arrangement and the operating environment.

Key Findings

11. The ANAO's view of the strengths of the current arrangement and the areas for improvement are summarised as follows:

Strengths

Actual costs in line with projections

12. Fixed price contracts have advantages including clearly identifying the outsourcer's costs under the contract and generally lower administrative costs compared to variable price contracts. One disadvantage can be unexpected additional costs arising from charges for services outside the scope of the contract. Additional costs of the DVA fixed price contract were relatively small. The ANAO considered that this was the result of a relatively stable operating environment and a good working relationship between DVA and the supplier.

A good working relationship between DVA and the supplier

13. The absence of any disputes under the contract is a primary indication of the good relationship developed between DVA and the supplier. Having a good relationship with the supplier enabled DVA to readily arrange additional storage, memory and the permanent and temporary increases in CPU capacity. In addition, in the last twelve months when DVA's IT environment has been less stable, the supplier has provided early warning of potential capacity problems.

Areas for Improvement

Evaluation of the achievement of expected outcomes

14. A formal evaluation of the level of achievement of expected outcomes of the current outsourcing arrangement has not been undertaken. The ANAO considers that it is highly

desirable for DVA to plan to undertake such an evaluation at an early stage of the next outsourcing arrangement.

Clear documentation of responsibilities

15. The current outsourcing arrangement involved no disruption to service delivery, with the NCC remaining as the data centre and being staffed in the main by former DVA staff. Such a continuation of the same physical services was the likely cause of operational responsibilities not being clearly defined when the outsourcing contract was signed. The contract provided for a detailed review to be undertaken by the supplier to clarify contractor and departmental operational responsibility boundaries. This review was not conducted and issues were addressed as they arose. Operational boundaries should be clearly defined and documented at an early stage of preparation for the next outsourcing arrangement.

Documentation of the management structure in DVA

16. There was a lack of documentation of the management structure in DVA for the management of the outsourcing relationship. Such documentation would include the identification of responsibility for monitoring and review of the outsourcing arrangement to ensure that the contract and service level agreement/s are kept up to date and reflect changing requirements.

Adequate documentation of procedures and distribution to staff

17. In addition to having an adequate contract, service level agreement/s, and a documented management structure with defined roles and responsibilities, there was a need for adequate documentation of procedures and its communication to relevant staff. Some of what might be expected to be included in such documentation is dispersed throughout the current contract.

Continued emphasis on resource planning and included in documentation

18. In the latter part of the current IT outsourcing arrangement, DVA's IT environment has changed from reasonably stable to less predictable in terms of capacity requirements. Steps have been taken by DVA to place a greater focus on resource planning and monitoring. DVA will need to continue to place emphasis on resource planning and monitoring including by adequately documenting the departmental requirements as part of the management arrangements.

The development of a contract and service level agreements that adequately reflect requirements and protect the interests of DVA

19. The current contract, which has been in effect since February 1992, was based on what DVA considered to be the best legal advice available at the time. There are a number of areas where the current contract and service level agreement (SLA) could be improved in the light of experience over the last four and a half years, particularly with regard to clarity and consistency. A number of changes to the contract and service level agreement were agreed by both parties but were not reflected as variations to the documents. The ANAO noted that the draft Request For Tender for the next outsourcing arrangement reflected a more comprehensive approach to the terms and conditions of the arrangement and had addressed relevant audit findings.

Recommendations

Set out below are the ANAO's recommendations with Report paragraph reference and DVA's abbreviated responses. More detailed responses and any ANAO comments are shown in the body of the report.

Recommendation No. 1 Para. 2.15	The ANAO recommends that DVA give priority to conducting an evaluation of the achievement of expected outcomes early in the life of the next outsourcing arrangement.
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Response: Agree.

Recommendation No. 2 Para. 3.9	The ANAO recommends that DVA document the management arrangements for the next outsourcing contract and communicate this to relevant staff. Such documentation should include the allocation of responsibilities between DVA and the supplier, the management structure within DVA and operational procedures including any undertaken jointly with the supplier.
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Response: Action has already been taken by the Department to address the matters raised.

Recommendation No. 3 Para. 4.8	The ANAO recommends that in the preparation of the contract for the next outsourcing arrangement, DVA ensure that the documents reflect the developments in the outsourcing industry and the outsourcing experience gained by the Department.
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Response: Action has already been taken by the Department to address the matters raised.

1. Introduction

This chapter provides the background to the audit including a description of the audit objectives and audit methodology.

Background

1.1 In February 1992, DVA outsourced its data centre in Sydney and became the first Commonwealth agency to outsource some or all of its information technology (IT) operations. Prior to this the Department's mainframe computing services were provided in-house at its National Computing Centre (NCC) in Sydney. The effect of the outsourcing arrangement was that the selected supplier purchased the NCC assets and DVA staff were given the options of continuing at the NCC working for the supplier, redeployment within the department or voluntary redundancy. The supplier also recruited additional staff.

1.2 The Federal Government's policy on IT outsourcing was set out in a Department of Finance Circular released in September 1991 which directed that agencies must examine all new IT projects and existing services with a view to them being outsourced, where this presents a better value for money alternative.

Audit objective

1.3 The objective of the audit was to review DVA's management of the outsourcing of its data centre in Sydney from February 1992, specifically with respect to the management of its contractual arrangements. The audit sought to identify the extent to which DVA achieved its objectives of outsourcing and the effectiveness of its management of the arrangement with the supplier. A secondary outcome of the audit is the production of a better practice guide on the management of IT outsourcing contracts in the Australian Public Sector, which will be published separately.

Audit methodology

1.4 The ANAO engaged a consultant, Sara Cullen, to advise on industry best practice in the management of IT outsourcing arrangements. In the first instance the audit looked to establish whether DVA had evaluated its outsourced arrangement to determine the level of achievement of expected cost savings and other benefits. Independent legal advice was also sought on the contract between DVA and the supplier.

1.5 Interviews were conducted with a wide selection of DVA staff including senior management, IT management, the outsourcing contract manager and IT staff with responsibility for liaison with data centre staff and DVA end users regarding, inter alia, the adequacy of service delivery under the outsourced arrangement. Discussions were also held with the management of the outsourcing supplier with respect to their views on the success of the arrangement.

1.6 The audit team, with the assistance of the consultant, provided DVA with audit findings that could immediately be put into practice in terms of better management practices and areas where the current outsourcing contract and service level agreement were deficient, and which could be addressed in the tender document for the next outsourcing arrangement before it went to the marketplace.

Conduct and timing

1.7 The conduct of the audit was timed so as to provide useful input to DVA's re-tendering process for the next outsourcing arrangement. The audit fieldwork was undertaken in June and July 1996 and the audit findings were discussed with DVA senior management in August and September 1996. The audit was conducted in accordance with the ANAO Auditing Standards. The cost of the audit was approximately \$185 000.

2. What the Outsourcing Arrangement Delivered?

This chapter identifies the overall outcome of the outsourcing arrangement following an ANAO assessment and comments on the lack of a departmental evaluation.

Actual costs in line with projections

2.1 While DVA has not undertaken a formal evaluation of the actual costs versus projected costs, monitoring arrangements had been put in place aimed at identifying any variations from

expected billing under the fixed price contract. The ANAO noted that this process identified that there were only a few instances where variations had occurred.

2.2 The ANAO also undertook its own analysis of actual costs compared to projected costs. The ANAO paid particular attention to identifying the main items of expense under the contract, namely, fixed price base charge, variable costs (differences from allowances) for consumables and couriers, software and other costs for additional CPU, memory and disk storage.

2.3 The ANAO identified that actual costs did not differ materially from projected costs. In the absence of an assessment as part of a formal DVA evaluation, the ANAO considers that this appeared to be the result of a stable operating environment and the supplier not imposing additional charges provided for under the contract. For example, excess CPU capacity was used by DVA in one third of the 24 months to June 1996. On each occasion excess capacity was used the supplier was entitled to increase the monthly charge, but no additional charge was levied.

Good working relationship

2.4 DVA and the supplier's senior management identified during the audit that the absence of any disputes under the contract was their prime indicator of a successful relationship. This enabled the outsourcing arrangement to operate smoothly even though some matters were not clearly defined in the contract and service level agreement. During the first half of the contract, a number of changes and clarifications were mutually agreed to without much apparent difficulty. The supplier was also very accommodating in providing additional storage, memory and permanent increases in CPU capacity.

2.5 There were also indications in DVA files that in the twelve months to July 1996 the supplier was monitoring DVA's capacity requirements (especially CPU) and provided advice as to impending capacity problems as an additional service at no extra charge under the contract. This included the temporary swapping of resources between operating and development environments to cover peaks in demand. Where the contract has not specifically defined requirements in a few circumstances, eg at the expiration of the contract, the supplier has not sought to take advantage of the situation.

2.6 The above examples of flexibility in the outsourcing arrangement attest to why the strategic relationship with the supplier is so important. With such give and take in the relationship there is less of a need to rely on the contractual provisions to clarify the day-to-day responsibilities of the supplier and customer.

2.7 DVA has suggested to the ANAO that the good relationship with the supplier was able to be developed as a result of the Department's careful process in selecting a supplier and the Department's efforts in establishing and fostering this good working relationship. The ANAO recognises the importance of the selection process to the development of a mutually beneficial relationship and also that effective contract arrangements rely on a good relationship between the parties. Nevertheless because it is not possible to foresee future events which may affect the departmental-supplier relationship, it is in the Commonwealth's interest to ensure contractual arrangements are comprehensive and reflect known contingencies. Further, the now more complex DVA operating environment and the broader scope defined by DVA for future outsourcing need to be factored into future contractual arrangements.

Benefits identified by DVA staff

2.8 During the course of the audit DVA staff identified a range of non-quantifiable benefits that flowed from the outsourcing arrangement. Those most frequently referred to included:

- improved communication through structured meetings;
- a more professional attitude of data centre staff (who had previously been DVA staff providing an internal service) including a greater focus on service delivery;
- a move to a 24 hour operation and the installation of an uninterrupted power supply;
- no need for an annual hardware upgrade as had been the case previously;
- known stable funding requirement rather than previous fluctuating requirements; and
- the streamlining of the pension payments process as a result of the supplier looking to minimise its exposure to incurring penalties caused by factors outside its control.

2.9 The ANAO acknowledges that these benefits identified by DVA staff should have been included in a departmental assessment of the added value provided by the outsourcing arrangement. An appropriately conducted independent evaluation by DVA would be expected to draw such relevant information together to deliver an overall assessment of the outcome of the arrangement.

Evaluation of IT outsourcing arrangements

2.10 DVA has not undertaken a formal evaluation of its IT outsourcing arrangements, even though there was an intention, as part of the Cabinet Submission relating to the original decision to outsource, to review the agreement by February 1996. Such a review was initially included in the Department's 1995-97 Portfolio Evaluation Plan (PEP) which was planned for commencement in July 1995 with an estimated completion date of November 1995. The current 1996-98 PEP includes a timeframe for the conduct of the evaluation during 1996 which the ANAO accepts is no longer feasible.

2.11 DVA has advised that it is no longer considered appropriate or cost effective to proceed with the evaluation in light of:

- the evident success of the current outsourcing arrangements based on the positive outcomes relating to cost savings (in the order of \$10m), service provision and other benefits referred to by the ANAO in this report;
- the involvement of the ANAO via the conduct of this audit and the recommendations and assistance provided relating to the new contractual arrangements;
- the internal IT audit coverage of operational arrangements and contract compliance; and
- the commencement of the tendering process for the next outsourcing arrangement

2.12 The ANAO acknowledges the successful outcomes of the current outsourcing arrangement in the form of actual costs being in line with projections for the required service delivery, a good working relationship with the supplier which resolved any emerging issues in a timely manner and additional benefits identified by DVA staff. However, the ANAO still considers that the formal evaluation should have been undertaken in accordance with the Department's PEP to inform the Minister and department of the success of the outsourcing initiative in terms of its objectives and the experience gained as a result.

2.13 This evaluation would have provided an assessment and detailed quantification of the cost savings and other benefits achieved. It may also have provided useful input to the request for tenders and draft contract for the next outsourcing arrangement. DVA itself identified in its PEP that the evaluation would provide information to DVA management and the supplier which would be instructive for future operational arrangements and in the negotiations on the extension or replacement of the contract.

2.14 The ANAO acknowledges that DVA has taken steps aimed at undertaking such an evaluation of the achievement of expected outcomes early in the life of the next outsourcing arrangement.

Recommendation No.1

2.15 The ANAO recommends that DVA give priority to conducting an evaluation of the achievement of expected outcomes early in the life of the next outsourcing arrangement.

Response

2.16 The Department agrees with the recommendation and has included in the terms of the next outsourcing contract a requirement for such an evaluation. The Department expects that the evaluation will take place in June 1998.

3. Operational Management of the IT Outsourcing Arrangement

This chapter comments on the adequacy of the Department's administration of the outsourcing arrangement.

Need for adequate documentation of the delineation of responsibilities

3.1 The outsourcing arrangement resulted in the NCC remaining as DVA's data centre with continuity of a major proportion of staff, including key staff. In terms of continuity of service delivery, this offered a number of advantages to DVA as it did not need to be concerned with migration of systems to another site staffed by people unfamiliar with its business. This level of continuity is likely to have resulted in DVA not finalising the split of responsibilities at the NCC between it and the supplier at the time the contract was signed in February 1992. As a result the contract and associated schedules did not fully specify the responsibilities of each party under the contract.

3.2 Instead, the contract required the supplier to undertake a detailed review of all NCC activities to clarify responsibility boundaries as soon as possible after the completion date, the date the contract was signed unless otherwise agreed. There is no evidence in the DVA management files that this review was undertaken. This issue was raised by DVA Internal

Audit in a July 1996 report on NCC Operations and Systems Environment Review. Included in that report is comment by the supplier that the division of responsibilities was performed in an informal manner, through management meetings and as issues arose.

3.3 The lack of adequate documentation regarding responsibility boundaries at the NCC does not appear to have caused DVA major problems or additional expense. The ANAO considers this is due, in the main, to the good working relationship established with the supplier.

3.4 The DVA Internal Audit report included reference to two areas of DVA/NCC operations where there was an established need for better documentation. One related to staffing changes during 1995 in the communications area at the NCC which highlighted that there was limited documentation of network change control procedures and the general division of responsibilities between the NCC staff and DVA IT communications support staff. The second related to the need for DVA staff to update run books used by NCC staff to schedule and run jobs. These run books describe systems and their associated jobs and the relationship to other systems. For both areas management advised that it would be improving the relevant documentation.

3.5 Adequate documentation of the delineation of all roles and responsibilities between DVA and the service provider for the next outsourcing arrangement will minimise the number of issues to be resolved during the life of the contract and provide a safeguard in the event any dispute might eventuate.

Need for better documentation of the management structure

3.6 Management of the current outsourcing arrangement extends beyond the day to day administration of the contract undertaken by the Business Unit Director. However, the ANAO could find little evidence that DVA had identified the necessary tasks to be performed as part of the adequate management of the arrangement and assigned them to particular positions. That is not to say that the tasks were not being undertaken, but rather that there was a lack of documentation which clearly identified responsibility for the various tasks. Details of the types of tasks suggested as appropriate for inclusion in the documentation of the assignment of responsibilities are identified by category in a matrix at [Appendix 1](#).

3.7 The next contract is likely to be more complex, with more services which are less mature than facilities management and in a less stable IT environment within DVA. Therefore, for the next outsourcing arrangement there will be a greater need for documentation to clearly identify responsibility for tasks, including frequency, that need to be performed (as indicated in Appendix 1). The risk of not identifying these particular responsibilities is that the outcomes of the arrangement may be less than expected.

Need for adequate documentation of procedures

3.8 As well as having appropriate documentation of the defined roles and responsibilities with the service provider and within DVA, there is a need for adequate documentation of procedures and communication of this documentation to all relevant staff. Some procedures that might be expected to be included in such documentation are spread throughout the

current contract and schedules. One way of assisting the development of an appropriate structure for the management of the next arrangement is to consider that:

- the contract sets out a course of action in case of dispute or failure to meet any of the terms of the contract;
- the service level agreement defines service success and how it will be measured; and
- the procedures documentation sets out how things get done. One aspect of operations such documentation would address would be to include copies of forms, and document procedures which will at times be relevant to both DVA and service provider staff, for example, in effecting variations to the service level agreement/s.

Recommendation No.2

3.9 The ANAO recommends that DVA document the management arrangements for the next outsourcing contract and communicate this to relevant staff. Such documentation should include the allocation of responsibilities between DVA and the supplier, the management structure within DVA and operational procedures including any undertaken jointly with the supplier.

Response

3.10 The Department advises that action has already been taken in relation to the matters raised as part of the arrangements in place for the next outsourcing arrangement.

Need for more comprehensive resource planning

3.11 Prior to the commencement of the tendering process for the current outsourcing arrangement DVA compiled projected capacity needs for a five-year horizon which formed the basis for contract negotiation. During the contract, on an annual basis, Information Management Unit managers were provided with details of actual workloads and were requested to provide advice of estimated/expected changes in workload for the next two years. This data was collated and forwarded to the supplier for information. There was no indication that such capacity forecasting was used to update a strategically focused capacity plan.

3.12 Up until September 1995 there was a stable DVA operations environment, actual requirements had not necessitated a re-negotiation of the original capacity projections in the contract and the annual review of workloads appeared to be adequate in the circumstances. However, changes since then affecting key DVA computer systems and the computing environment in which they are developed, have resulted in a significantly changing profile of capacity requirements. The extent of the impact of the system and environment changes on capacity requirements had not been anticipated by DVA to enable more frequent monitoring of capacity usage.

3.13 During this recent period of significant change, DVA files indicate that the supplier staff were providing the department with an early warning service when processing capacity required was stretching capacity availability and was likely to cause processing problems with deadlines being missed. This did not appear to be a specific task covered by the contract base

charge. However, the supplier has indicated to the ANAO that it is an activity undertaken to ensure service delivery obligations are met. Along the same lines, there were instances where the supplier temporarily shifted processing capacity between the various IT mainframe environments (production, acceptance testing and development) so as to provide maximum capacity for peak production workloads.

3.14 During 1996 DVA has undertaken steps to upgrade its capacity planning with the establishment of an area responsible for corporate capacity planning covering both the mainframe and local area network environments.

3.15 Following the establishment of the Information Management Steering Committee in September 1995 DVA has placed more emphasis on the need to include more comprehensive information in IT project submissions. Such submissions are now required to include the identification of the effects on IT infrastructure requirements and any proposals for increased resources (including computing capacity), and the lead time required for IT project development and implementation which would provide useful input with which to manage capacity. The ANAO considers that the conduct of effective monitoring of capacity usage in conjunction with appropriate long term capacity planning would ensure that potential capacity problems are identified earlier and a range of options considered before a decision is taken.

Need for more comprehensive record keeping

3.16 The ANAO found it difficult to obtain a full appreciation of DVA's role in the resolution of issues as they arose and proposals to improve service delivery due to incomplete documentation on DVA files. This situation was exacerbated by the fact that key DVA staff initially involved in the management of the outsourcing arrangement had either left the department or had moved. Staff currently involved with the outsourcing arrangement only had recent knowledge of issues addressed by DVA and the supplier, while staff who had moved had difficulty recalling the detail of matters discussed and action taken, especially with respect to periodic meetings. Gaps in the DVA records resulted from a combination of causes including:

- inadequate documentation of matters discussed at meetings; and
- relevant material being placed on subject matter files, with no copy on the contract management files.

3.17 The ANAO has brought to DVA's attention the benefit of maintaining an adequate trail of the management of the current and the next outsourcing arrangement, including issues addressed and decisions taken.

4. The Contract and Service Level Agreement

This chapter provides comment on the contract and service level agreement for the outsourcing arrangement.

Need for improved contract and service level agreement/s (SLA)

4.1 The ANAO recognises that the contract for the current outsourcing arrangement was formulated on the basis of what DVA considered at the time was the best legal advice available. Many developments have occurred in the IT and outsourcing industries in the intervening four and a half years and the Department acknowledges that the contract can be improved in a number of areas.

4.2 The need for variations to the contract and schedules (in effect including SLA features) was identified at an early stage of the outsourcing arrangement. In the absence of a contract clause identifying the means by which variations should be effected, necessary amendments were agreed between DVA and the supplier, evidenced on various DVA files but not formally adopted as part of the contracted arrangement. An attempt was made by the first Business Unit Director to formally recognise the differences between the contract requirements and what was happening in practice.

4.3 A comprehensive draft compendium of differences was compiled in early 1995 and was tabled at an NCC Management Review Meeting. There was no evidence that this compendium was finalised in the absence of an established variation approval process. The draft Request For Tender for the next arrangement addressed the need for approval of variations to the contract.

4.4 In addition, as part of the audit of the management of the outsourcing arrangement the ANAO undertook a review of the DVA Computing Services Agreement with the supplier. The ANAO was assisted by a consultant who has extensive experience with IT outsourcing contracts. Some overall comments which follow are intended to highlight the strengths of the current contract and areas for improvement and give guidance for future contracts. More detailed comments have been provided to DVA as part of the discussions of the audit findings to assist with the formulation of documentation for the re-tender process for the next outsourcing arrangement.

4.5 The ANAO also sought independent legal advice on the contract in order to obtain informed comment from both the IT outsourcing and legal points of view. The legal advice identified similar deficiencies in the contract.

4.6 The contract has a good use of schedules (for easy reference and amendment) but combines contract issues with SLA and general procedures. In the light of emerging experience and good practice over the last four and a half years, the contract could have been more clear and concise. Examples include:

- inconsistency between the schedules and the contract. In addition, there is no clause which states that where there is an inconsistency between the contract and the schedules, the schedules will prevail;
- absence of key definitions and poor definition of items. As a result it is not always clear to what a particular use of words is referring;
- inadequate coverage of some of the usual terms of the contract including warranties on the part of the contractor, intellectual property rights, performance review and remedies if the Commonwealth is dissatisfied and the variation process previously mentioned; and
- some vague clauses including some with the potential to cause difficulties in determining service provision.

4.7 As part of the development of an appropriate contract for the next outsourcing arrangement DVA should revisit the information it requires to be reported periodically by a supplier and revise the report format as requirements change.

Recommendation No.3

4.8 The ANAO recommends that in the preparation of the contract for the next outsourcing arrangement, DVA ensure that the documents reflect the developments in the outsourcing industry and the outsourcing experience gained by the Department.

Response

4.9 The Department advises that action has already been taken in relation to the matters raised as part of the arrangements for the next outsourcing arrangement.

4.10 The Attorney-General's Department, which is working with DVA on the development of a contract for the next outsourcing arrangement, has advised that the matters raised are considered to have been addressed in recent work done in the preparation of the new contract.

5. The Next IT Outsourcing Arrangement

This chapter addresses a number of issues relevant for consideration by DVA for the next IT outsourcing arrangement.

Expectations and lessons for next outsourcing arrangement

5.1 As the focus of the audit was looking forward to the next outsourcing arrangement the ANAO noted the establishment of a project team, the development of project plans and tasks undertaken in preparation for the next arrangement. Some comments follow in relation to the next IT outsourcing arrangement.

5.2 Discussions with DVA and supplier staff, review of relevant files and the ANAO's own research have resulted in an overall view that the IT outsourcing world, the understanding and objectives of customers and suppliers and the environment within which IT outsourcing is undertaken have changed much in five years. The ANAO acknowledges the approach being taken by the Department in the formulation of contract requirements for the next arrangement. This is not so much a matter of taking the previous contract and refining it to better suit DVA's new situation, but taking account of advances in the outsourcing industry, the changed departmental IT environment and the Department's broader requirements which can impact the structure of a contract.

5.3 Some of the more important issues are being addressed by DVA as part of its planning process for the next IT outsourcing arrangement, including alignment of IT outsourcing with departmental goals and objectives, and corporate and IT strategic plans.

5.4 In the event that DVA moves towards flexible pricing for an outsourced arrangement of wider scope in a developing operational environment, the ANAO considers the Department will need to address the appropriate management structure and audit requirements to put in place to minimise the risk of potentially increased costs in this more complex situation. Industry experience, as advised by the ANAO consultant, indicates that when audits have

been undertaken of flexible price contracts for the same services as DVA has currently contracted out, it was found that suppliers overcharged fairly regularly. The contracts for which this has occurred have been priced based on CPU use at different times during the day and based on the type of service e.g. batch versus real time processing and application development versus maintenance. Examples of problems referred to by the consultant as encountered in the industry include:

- CPU calculations have been incorrect (particularly at the start of the contract) and the wrong rates applied;
- suppliers charging system development rates for maintenance (because it was not clearly defined); and
- suppliers charging for testing resources using the customer's prime time CPU rates (should not have been charged at all).

5.5 The original SLA manager (Business Unit Director) needed 18 months of full time effort to become familiar with the requirements of the SLA manager's position, and it later consumed an average of 30 to 40 per cent of his time. The current SLA manager spends approximately 50 per cent of her time managing the outsourcing arrangement with the supplier. This time has been gradually increasing due to the additional workload associated with the changing IT environment in DVA in the last 12 to 18 months. It is anticipated that there will again be a period of initial intensive effort required for the management of the next contract and SLA particularly if the scope of outsourcing is extended beyond the Facilities Management area.

5.6 The ANAO notes that DVA is expecting the person heading up the tendering project for the next outsourcing arrangement to have a key role in the management of the new contract when implemented. This should provide an appropriate knowledge base and level of understanding for the management of the next arrangement. DVA will also need to assess the expected resource requirement for the management of the next arrangement, both initially and in the longer term. The extent of outsourcing undertaken, including the number of service providers and the role of a prime contractor, is likely to be a major factor in the assessment.

5.7 The ANAO will plan to conduct a follow-up to this audit by way of a review of the next outsourcing arrangement entered into by DVA. The timing of the follow-up audit will take into account the timeframe for implementation of the next arrangement and the Department's own evaluation and audit activity.



Canberra ACT

11 December 1996

P. J. Barrett

Auditor-General

Appendix 1 - Contract Management Activity Matrix

Process	Design/Plan	Assess/Evaluate	Authorise/Approve	Audit	Negotiate	Investigate
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<i>Relationship Management</i>	1. Communication interface roles and processes 2. Meetings - agendas, timing, attendees, deliverables and documentation 3. Report content and frequency	1. Effectiveness & efficiency of key personnel of both parties 2. Impact of supply point changes 3. Stakeholder needs being met	1. Requests for personnel changes 2. Use of sub-contractors 3. Changes in supply points 4. Information request responses		1. Issue resolution 2. Contract and SLA variations	1. Relationship problems
<i>Supplier Performance</i>	4. Performance metrics 5. Reporting content and frequency	4. Performance trends 5. Effectiveness of metrics as "good service" indicators	5. Performance reports 6. Improvement ideas	1. Performance reporting source data & programs 2. Compliance with best/standard practice	3. Improvement ideas	2. Performance issues
<i>Agency Performance</i>	6. Accountabilities & procedures to ensure responsibilities are met	6. Performance and cost trends 11. Impact of poor performance on cost, timing and deliverables	7. Improvement ideas	3. Quality & timeliness	4. Improvement ideas	3. Performance issues
<i>Agency Use of Supplier Services</i>	7. Accountabilities and procedures to ensure use of supplier is controlled 8. Forecasting procedures	8. Strategic and operational goal achievement 9. Usage trend analysis:	8. Out of scope service use 9. Improvement ideas	4. Internal controls	5. Variations based on actual use and/or forecasts 6. Improvement ideas	4. Actual vs planned usage
<i>Price and Billings</i>	9. Reporting and forecasting requirements and procedures	10. Open books 11. Actual to budget 12. Trends 13. Formulas	10. Supplier invoices 11. Annual forecast	5. Billing practices, formulas & data 6. Open books 7. Value for	7. Price changes 8. Disputed billings	5. Actual compared to forecast 6. Industry price standards

				money		
<i>Penalty Points and/or charges</i>	10. Procedures, formulas & approvals required	14. Trends	12. Requests for application	8. Formulas	9. Application	7. Potential application
<i>Contract, SLA , and Procedure Manual Variations</i>	11. Administration requirements 12. Variation request and implementation procedures	15. Impact of variation requests 16. Variation type and cost impact trends:	13. Variation request forms 14. Drafts and final variation	9. Documentation held at supplier	10. Intent 11. Exact wording 12. Price and performance level impact	8. Potential variations
<i>Supplier Viability and Capability</i>	13. Information required to perform assessments	17. Strategic direction synergy 18. Financial strength 19. Ownership 20. Impact of internal and external events		10. Internal controls 12. Contract clause compliance: insurance performance bonds	13. Contract variations	9. New market offerings 10. New major customers 11. Actions/claims 12. Strategic direction 13. Media reports on Supplier
<i>Intellectual property Rights (IPR)</i>	14. Need to evidence or perfect Agency 15. Ownership	21. Potential exploitation	15. Exploitation agreement	12. Compliance		14. Potential IPR issues
<i>Confidential Information</i>	16. Requirements 17. Confidentiality classification scheme		16. Disclosure requests 17. Personnel confidentiality agreements	13. Compliance	14. Proposed disclosures	15. Potential threats
<i>Each Project with Supplier</i>	18. Requirements	22. Need for variations to procedure manuals 23. Deliverables	18. Project plan and deliverables 19. Non conforming deliverables: requests for	14. Project success	15. Price impact of scope changes 16. Remedy of non-conforming	16. Progress

			remedy		deliverables	
			remedy proposals			

Appendix 2 - Performance Audits in the Department of Veterans' Affairs

Set out below are the titles of the reports of the main performance audits by the ANAO in the Department of Veterans' Affairs tabled in the Parliament in the past three years.

Audit Report No.7 1995-96

Financial Management

Department of Veterans' Affairs

Audit Report No.3 1996-97

Compensation Pensions to Veterans

and War Widows

Department of Veterans' Affairs

Audit Report No.6 1996-97

Commonwealth Guarantees, Indemnities

and Letters of Comfort

Audit Report No.16 1996-97

Payment of Accounts