

The Auditor-General
Audit Report No.20 2006–07
Performance Audit

Purchase, Chartering and Modification of the New Fleet Oiler

Department of Defence

Defence Materiel Organisation

Australian National Audit Office

© Commonwealth
of Australia 2007

ISSN 1036-7632

ISBN 0 642 80939 9

COPYRIGHT INFORMATION

This work is copyright. Apart from any use as permitted under the *Copyright Act 1968*, no part may be reproduced by any process without prior written permission from the Commonwealth.

Requests and inquiries concerning reproduction and rights should be addressed to the Commonwealth Copyright Administration,
Attorney-General's Department,
Robert Garran Offices,
National Circuit
Barton ACT 2600

<http://www.ag.gov.au/cca>



Canberra ACT
30 January 2007

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Department of Defence and Defence Materiel Organisation in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *Purchase, Chartering and Modification of the New Fleet Oiler*.

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

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian McPhee', is positioned above the printed name.

Ian McPhee
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

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

For further information contact:
The Publications Manager
Australian National Audit Office
GPO Box 707
Canberra ACT 2601

Telephone: (02) 6203 7505
Fax: (02) 6203 7519
Email: webmaster@anao.gov.au

ANAO audit reports and information about the ANAO are available at our internet address:

<http://www.anao.gov.au>

Audit Team

Claire Dunstall
Andrew Sibraa
Colin Cronin

Contents

Abbreviations.....	7
Summary and Recommendations	9
Summary	11
Background	11
Key findings.....	14
Overall audit conclusions	21
Agency response	22
Recommendations	24
Audit Findings and Conclusions	25
1. Introduction	27
Background	27
Amphibious and Afloat Support System Program Office	33
Audit approach	34
Report structure	34
2. Project Approval and Ship Purchase	36
Background	36
Kinnaird Report - strengthened two-pass approval system	38
Project approval	41
Purchase of the DELOS.....	41
3. DMO Chartering of the DELOS.....	53
Background	53
Banking arrangements	55
Contract management.....	57
Commonwealth Financial Framework.....	62
Goods and Services Tax.....	69
4. Modification of the DELOS.....	72
Background	72
Tender evaluation	74
Vessel Modification Contract	77
Contractual Acceptance	85
Appendix	93
Appendix 1: Defence and DMO Response	95
Index.....	97
Series Titles.....	98
Better Practice Guides	100

Tables

Table 1	DMO assessment of the HMAS WESTRALIA Replacement Project.....	13
Table 1.1	Defence Capability Plan 2004–2014: Project SEA 1654	29
Table 2.1	Key events relating to the purchase of the DELOS.....	38
Table 2.2	Expenditures of significant contractors during the ship selection and purchasing phase: November 2003 to June 2004	43
Table 2.3	Base ship selection evaluation criteria and Project Office assessments.....	48
Table 2.4	Comparison of recorded and actual Project cash expenditure for the DELOS purchase.....	52
Table 3.1	Key events relating to the commercial chartering of the DELOS: June 2004 – June 2006	54
Table 3.2	DMO Financial Investigation Service audit finding: June 2006	62
Table 3.3	Agency responsibility for appropriation management	64
Table 3.4	Defence and DMO adherence with the Commonwealth Financial Framework as at 31 March 2006.....	67
Table 3.5	Australian Government Solicitor legal advice on public money	68
Table 4.1	Key events relating to the modification of the DELOS	73
Table 4.2	Defence advice on safety framework for SIRIUS	80
Table 4.3	Safety related tests and trials not competed at Contractual Acceptance: 7 August 2006	88
Table 4.4	Safety related deficiencies as identified by RANTEAA: August 2006	90

Figures

Figure 1.1	Arrangements for the management of the DELOS during the commercial charter period (June 2004 to August 2005)	33
Figure 2.1	DMO analysis in June 2006 of price trends in the relevant product tanker market (2002 to 2006)	45
Figure 2.2	Payments process for the DELOS purchase.....	51
Figure 3.1	DMO internally audited DELOS charter and vessel management payments and receipts: as at 31 May 2006.....	57
Figure 4.1	Modification works to be completed by the DMO Project.....	74
Figure 4.2	Record of Modification Contract payments to 30 June 2006	85

Abbreviations

AASSPO	Amphibious and Afloat Support System Program Office
ABR	Australian Books of Reference
ADAS	Amphibious Deployment and Sustainment
AEO	Authorised Engineering Status
AMPS	Automated Maintenance Planning System
ANAO	Australian National Audit Office
AGS	Australian Government Solicitor
DCP	Defence Capability Plan
Defence	Department of Defence
DLOC	Defence Level of Capability
DMO	Defence Materiel Organisation
DTMO	Defence Tax Management Office
Finance	Department of Finance and Administration
FMA	Financial Management and Accountability
GST	Goods and Services Tax
HRMI	High Risk Maintenance Items
IACS	International Association of Classification Societies
IMO	International Maritime Organisation

MARPOL	International Agreement for the Prevention of Maritime Pollution
MOSC	Maritime Operations Support Capability
NAVSAFE	Navy Safety Manual
NTRM	Navy Technical Regulations Manual
NTRS	Navy Technical Regulatory System
OQE	Objective Quality Evidence
RANTEAA	Royal Australian Navy Test Evaluation and Acceptance Authority
RAS	Replenishment at Sea
RHIBs	Rigid Hull Inflatable Boats
ROMAN	Resources and Output Management and Accounting Network (ROMAN) system
SC	Safety Case
SPO	System Program Office
TCE	Time Charter Equivalent (Earnings)
WSSC	Whole Ship Safety Case

Summary and Recommendations



Source: DMO records

Summary

Background

1. The fleet oiler HMAS WESTRALIA was a key element of the Royal Australian Navy (hereafter referred to as 'Navy') Maritime Operations Support Capability (MOSC) from 1989 until September 2006. WESTRALIA provided logistic support to naval operations and exercises and contributed to Defence international engagement through these activities. The new vessel to replace WESTRALIA is called HMAS SIRIUS and was commissioned by Defence in mid September 2006, which was concurrent with the formal decommissioning of WESTRALIA. This approach was adopted by Defence to ensure that Navy maintained a continuous afloat support capability.
2. The WESTRALIA Replacement Project requirements and delivery schedule were influenced by Navy's intent to continue to comply with Australia's international obligations as set under the International Maritime Organisation's Maritime Pollution (MARPOL) agreement. This agreement is the main international convention covering the prevention of pollution of the marine environment by ships, but provides an exemption for naval vessels.
3. Under MARPOL, WESTRALIA was classified as a single hull tanker. Project SEA 1654 Phase 2A (hereafter referred to as 'the Project') was aimed at delivering an environmentally compliant, double hull, tanker to the Navy. The Project, which proposed the purchase and modification of a commercial vessel, was approved by Government in March 2004. In the Defence Portfolio Budget Statements 2006–07, Defence reported that the approved Project budget at that time was \$143 million, with \$102 million expended and \$32 million to be expended in 2006–07. The total reported Project expenditure to 31 October 2006 amounted to \$118.74 million.
4. Based on the initial Base Ship Specification and List of Modifications, Defence and the Defence Materiel Organisation (DMO),¹ supported by a number of contractors, conducted a worldwide search of operating tankers to produce a short list of vessels that were compliant with the Base Ship Specification. Detailed inspections of three vessels were conducted, with a decision made to purchase the preferred vessel in late May 2004. The Commonwealth purchased an environmentally compliant, double hull

¹ On 1 July 2005, the DMO was established as a Prescribed Agency under the *Financial Management and Accountability Act 1997*.

commercial 'off-the-shelf'² product tanker named Merchant Tanker DELOS for \$US35.7 million,³ which was delivered to DMO in mid June 2004.

5. Following the purchase of the DELOS, DMO entered into the Navion Timecharter Agreement (known as the 'Navion Contract'), for the commercial time charter⁴ of the DELOS, with Teekay Chartering Limited Marshall Islands (hereafter referred to as 'Teekay Chartering') in early July 2004. The initially agreed rate of hire was US\$15 000 per day, payable monthly in advance. DMO reported that it principally entered into the time charter arrangement to provide the Navy with sufficient operational experience on the DELOS to inform the design and modification process. For the charter period of July 2004 to August 2005, DMO reported total charter revenue of \$8.22 million.

6. During the period of the charter of the DELOS, the Commonwealth signed a fixed-price, milestone based contract with Tenix Defence Pty Ltd (hereafter known as the 'Prime Contractor') to modify the DELOS, as envisaged, in order to provide Navy with a vessel capable of conducting underway replenishment of fuel (diesel and aviation) and water. The initial Contract value was \$63.055 million. The Contract value was initially to be paid in 14 milestone payments over 18 months, ending with the scheduled delivery and acceptance of the modified vessel on 15 September 2006.

7. The audit examined the purchase of a commercial 'off-the-shelf' oil product tanker in June 2004, its chartering from July 2004 to August 2005, and its subsequent modification to fulfil the role as the Navy's new fleet oiler. The modification of the purchased vessel was conducted at the Henderson Common User Facility, located south of Fremantle, Western Australia. The DMO provided the ANAO with an overview assessment of the Project in October 2006 (see Table 1).

² The 2005 Defence Capability Development Manual states that an 'off-the-shelf' product is defined as one that is available for purchase, and will have been delivered to another military or government body or commercial enterprise in a similar form to that being purchased at the time of the approval being sought (first or second pass).

³ The amount recorded by Defence's financial management system is \$52.2 million but the amount actually paid was \$51.1 million due to currency recording.

⁴ The time charter involved the 'wet lease' of the DELOS where DMO was responsible for covering all costs including crew, provisions and supplies, maintenance and insurance, but excluding charter related fuel costs, port charges and associated fees which were generally borne by the Teekay Chartering.

Table 1**DMO assessment of the HMAS WESTRALIA Replacement Project**

Project SEA 1654 Phase 2A has provided a new capability (NUSHIP SIRIUS) for the Royal Australian Navy. The commissioning of the Auxiliary Oiler NUSHIP SIRIUS will coincide with the end of service for HMAS WESTRALIA.

The new Auxiliary Oiler is a double hull, environmentally sustainable vessel, built in the Republic of Korea by the Hyundai Mipo Dockyard Company. The ship was commissioned HMAS SIRIUS in a traditional naming ceremony on 16 September 2006.

There are a number of ‘home truths’ that have been reinforced by DMO’s experience with this project.

The first is that the purchase and conversion of an existing commercial oiler, the MT DELOS, is a striking example of the efficiency that can be gained from the purchase of ‘off-the-shelf’ products where that is appropriate for our capability requirements. DMO paid A\$52 million for a vessel that is 176 metres in length and has the capacity to carry 37,000 tonnes of cargo.

Secondly, the DMO’s business-like approach to the use of different methods of contracting has been vindicated. The DMO continues to be innovative and look for the best contracting method based on the risk profile of each project. In this case, knowing there would be obstacles if our identity as a Government organisation was disclosed, we decided to purchase the vessel on the open market using a private contract that met all international standards. The DMO then continued to be innovative by leasing the vessel back to the market while it undertook the competitive tender process for the refit activity.

Thirdly, the DMO were highly responsive to Government. The requirement under the original Defence Capability Plan was for a vessel to be delivered in 2009 and a project budget of about \$450 million. That plan was substantially revised by Government following the Capability Review (November 2003). Changes to international regulatory standards have led to an accelerated timetable for the withdrawal of single hull oil tankers like the WESTRALIA. Although warships are not strictly bound by these regulations, the environmental impacts and the risk of limited future access to international waters were key factors in the Government decision to bring forward the replacement of the WESTRALIA from 2009 to 2006.

Finally, the project has been a good example of achieving results in partnership with industry. The contract for the refit and modification of the tanker was awarded to Tenix, with the majority of the work completed in Western Australia. The contract included incentives for completing the work ahead of schedule. Over a period of 18 months, and with a number of difficult issues to resolve along the way, Tenix completed the work on budget and have received incentives for completing the work ahead of schedule.

Afloat support ships like SIRIUS are a force multiplier, boosting Australia’s maritime capability by keeping combatant ships at sea for longer periods and allowing them to operate at greater ranges from port. SIRIUS will commence her service with some of the most modern equipment available, and will play an important role in afloat support for the Navy fleet for many years.

For the first time in most people’s living memory a first-of-class ship of this size has been delivered not only ahead of schedule but also under budget.

Source: DMO advice to ANAO, 23 October 2006.

Key findings

Project approval and ship purchase (Chapter 2)

8. The Defence White Paper 2000 (the 'White Paper') had identified the requirement to replace WESTRALIA upon its anticipated retirement from service in 2009.⁵ Between 2003 and 2006, Defence implemented operational limitations, including limiting the maximum amount of fuel to be carried, which resulted in WESTRALIA being reclassified to ensure continued compliance with MARPOL. Defence's management strategy for WESTRALIA was highly adaptive to recent MARPOL developments in that it extended WESTRALIA's operational life to over 27 years, maintaining class certification and MARPOL compliance until retirement in September 2006.

9. In early March 2004, Government accepted a proposal of the September 2003 Defence Procurement Review (also known as the 'Kinnaird Report') that Defence Capability Plan Projects with a 2003–04 or 2004–05 year of decision should progress directly to Government second pass approval consideration. The Project was identified by Government in March 2004, on advice from DMO, as falling into this category. The strengthened two-pass approval system was to be fully implemented for projects with a 2005–06 year of decision or later. With Government second pass approval achieved in late March 2004, the Project was authorised to purchase a commercial tanker as the base ship and modify it for Navy service.

10. The Evaluation Plan for the base ship purchase identified that a tiered set of performance-based selection criteria would be used to evaluate the suitability of short listed vessels.⁶ Final suitability assessments were made against criteria for vessel performance (50 per cent), program (30 per cent)⁷ and commercial (20 per cent) aspects. The ANAO observed that while the DELOS and the 2nd Ranked Ship⁸ were assessed as being equivalent against the performance and commercial criteria, the overall assessment was determined

⁵ Prior to the initiation of the Project to replace WESTRALIA, Defence had identified a number of shortcomings in WESTRALIA's capability that limited the vessels utility in supporting operational deployments.

⁶ The total performance rating for each ship was compared to the prospective purchase price to produce a value for money rating (quotient).

⁷ The program criterion was based on sub-criteria for availability (60 per cent), owner's reason for sale (10 per cent) and spend profile (30 per cent).

⁸ The Base Ship Selection Report, produced by DMO immediately prior to the Base Ship's selection and purchase, identified that the price of the 2nd Ranked Ship was approximately US\$3 million less than the DELOS.

by the program criteria, where the DELOS achieved a significantly higher rating due to it being available for sale prior to 30 June 2004.⁹ DMO subsequently advised the ANAO that the purchase of the DELOS was the correct decision as the purchase of a new ship meant that DMO received both a warranty period for defects, and access to the Shipbuilder's design information, which may not have been available had it purchased an older vessel.

11. Defence capability guidance of June 2002 had identified that WESTRALIA, because of its maximum speed of 16 knots, was not able to fully integrate with any Task Group that required flexibility to operate at higher speeds. The capability guidance also stated that ships within the maritime operations support capability should have a maximum speed in excess of 18 knots. The original capability objective was lowered to 14 knots in November 2003, in line with the reduction in the forecast Project budget from \$450 million to \$150 million, and Defence's decision to pursue a commercial tanker as a base ship which was a ship design with a maximum economical speed of around 14.5 knots.¹⁰ Against the revised capability guidance, DMO acquired the DELOS for US\$ 35.7 million in June 2004, following which the DELOS regularly achieved sustained speeds of between 15 and 16 knots during its commercial charter.

DMO chartering of the DELOS (Chapter 3)

12. The decision to charter the vessel for a short period following its purchase was taken once an assessment was made of the design data available for the DELOS. DMO entered into a Ship Management Agreement (hereafter known as the 'Shipman Contract') with Teekay Marine Pty Ltd (hereafter known as 'Teekay Marine') in early June 2004. Through the Shipman Contract, the DMO outsourced the commissioning and operation of the DELOS, which included crew, technical and commercial management, to Teekay Marine.

13. The DMO construct for the commercial charter of the DELOS provided for the cost of Teekay Marine's services to be covered by the time charter hire charges earned by DMO under the Navion Contract with Teekay Chartering.

⁹ By comparison, DMO reported that the 2nd Ranked Ship was under charter and that this may restrict delivery with a consequent impact on the short term spend profile requirement of spending the money in that financial year.

¹⁰ Alternative ship designs that may have permitted higher operational speeds, such as container ships, were eliminated from consideration at an early stage as their subsequent modification was considered a high risk in terms of Australian industry ability, cost and schedule.

DMO permitted the charter of the DELOS to operate on this basis after concluding that the charter monies did not become public funds until the Shipman Contract had been reconciled and monies were due and payable to the Commonwealth.

14. Under the Shipman Contract (Clause 7.1), all funds collected by Teekay Marine, and any interest thereon, were to be held to the credit of the Commonwealth in a separate bank account.¹¹ Between July 2004 and September 2005, hire charges of \$8.22 million were paid by Teekay Chartering to Teekay Shipping as agent of the Commonwealth under the Navion Contract. Teekay Shipping advised that these public funds were banked and maintained in a Teekay Shipping working bank account on behalf of the Commonwealth.¹² Over the charter period, and in accordance with the payment construct agreed by DMO, Teekay Marine acquitted its commercial charter expenses of \$7.60 million against the public money charter receipts held in the Teekay Shipping bank account.¹³

15. Teekay Shipping advised the ANAO in December 2006 that:

According to standard industry practice, this clause [Clause 7.1] does not infer a DMO or a specific Commonwealth bank account but implies the funds are held in a separate account to ensure they are held to the credit of the Commonwealth. This was the case in this situation where funds were held in an account where Teekay were able to differentiate the DMO funding. There is hence no requirement in the Shipman Contract to deposit funds into a Commonwealth bank account.¹⁴

16. A separate, Official bank account for the Commonwealth was not established by DMO until June 2006. The remaining balance of the charter

¹¹ The Shipman Contract Clause 7.1 requires that: All moneys collected by the Managers under the terms of this Agreement (other than moneys payable by the Owners to the Managers) and any interest thereon shall be held to the credit of the Owners [Commonwealth] in a separate bank account.

¹² DMO documentation of February 2006 notes that Teekay does not/has not maintained a separate bank account for the management of the DELOS on behalf of the Commonwealth. All the ships they manage are covered under the one bank account.

¹³ From September 2005 to mid 2006, Teekay Marine acquitted further expenses of \$1.34 million, relating to its services to DMO in respect to its ongoing management of the DELOS, from the Teekay Shipping bank account.

¹⁴ Teekay Shipping advised the ANAO in December 2006 that:

When the most recent audit commenced, a full reconciliation of the Advance Account (basic summary including receipted and expensed amounts and full backup of bank statements where requested) were forwarded to the audit team – the balance was agreed to be correct and all interest and funds were subsequently transferred to the new account opened by the DMO. At no stage prior to the ANAO/DMO audit, did the DMO advise that a separate Commonwealth bank account would be required.

revenues, an amount of \$683 547, was paid to the DMO on 29 June 2006.¹⁵ Technically, DMO should have received at least monthly invoices to support and acquit the withdrawal of public funds, and issued Teekay Marine with a validly authorised drawing right to expend these public funds, which have been assessed by the Australian Government Solicitor to be part of Defence's and DMO's appropriations. Teekay Shipping advised the ANAO in December 2006 that the customer [DMO] had agreed to a budget at the start of the period (the commissioning phase) and any funds thereafter would be used during the next phases if in surplus.¹⁶ It is standard industry practice, and in accordance with the Shipman Agreement, that the ship manager should have funds in advance.

17. Defence advised the ANAO in December 2006 that:

An informed business decision was made by the DMO to use innovative methods to reduce risk and to achieve a positive outcome for the Commonwealth. The DMO and Commonwealth do not usually undertake the role of leasing vessels to commercial operators and for the Commonwealth to adopt anything other than commercial practices for the contracting and operations of the vessel would have placed a much higher risk upon the Commonwealth than was the case in this lease. The audit by the DMO Financial Investigation Service found that the Commonwealth was paid all the revenue that it was owed.

18. Based on an audit by DMO's Financial Investigation Service in mid 2006, DMO advised the ANAO that it was satisfied that all commercial charter revenues and expenses were correctly reported. In the course of the ANAO's audit, the ANAO had observed administrative weaknesses relating to the chartering of the DELOS to Teekay Chartering by the DMO, and issues concerning adherence with elements of the *Financial Management and Accountability Act 1997 (FMA Act)*, concerning the custody and banking of public funds and the authority for the withdrawal of appropriated public

¹⁵ On 4 July 2006, DMO transferred \$546 723 into the new Official bank account, which was \$683 547 less the \$136 794 interest earned on the net charter revenues.

¹⁶ Teekay Shipping advised the ANAO that:

The DMO requested 'health checks' and audits (which in fact occurred three times prior to the most recent audit) to ensure that the accounts were prepared in a true and correct manner and there was in fact minimal requests for monthly accounts from the DMO, apart from various progress reports that were made available on ad-hoc basis and some financial reports that were sent to the DMO at various intervals. Although the DMO required infrequent reports, Teekay have stringent reporting requirements and completed a full set of accounts for the DELOS each month – these reports were available to the DMO at any point in time. It was always emphasized, even during prior audits, that our books are always open for inspection if required. In fact at various intervals during the prior audits, full sets of the Operating expenditure reports were sent to the DMO.

funds, and requirements of the Goods and Services Tax legislation (*GST Act*). This highlights that the risk of contravention of the Commonwealth Financial Framework can increase with transactions that are unusual or infrequent. The ANAO considers that, in such circumstances, a higher level of analysis or review often assists in mitigating risks.

Modification of the DELOS (Chapter 4)

19. The vessel modification design and production program, which was approved at the time of the Project's approval in late March 2004, was allocated \$76 million. The elements of the modification work included: accommodation, communications and sewerage treatment plant upgrades; and the installation of a solids cargo container deck; replenishment at sea equipment, flight deck and rigid hull inflatable boats.

20. The Modification Contract included an incentive payment regime to provide an additional incentive for the Prime Contractor to deliver the modified vessel to DMO on or before the scheduled completion date of 15 September 2006. The maximum incentive payment of \$1 million was to be payable to the Prime Contractor in the event that the modified vessel be delivered to the DMO on or before 31 July 2006 and was subsequently accepted in the delivered state.¹⁷ With the exception of some Contract Change Proposals and items of Government Furnished Equipment, the DMO reported that the Prime Contractor offered the modified vessel to DMO for acceptance on 7 August 2006.

21. The DMO contractually accepted the modified vessel on the same day, which was prior to the completion of its test and evaluation activities. On this basis, the Prime Contractor may have been entitled to an incentive payment of \$0.75 million for the early delivery and DMO contractual acceptance of the ship. Defence advised the ANAO in early August 2006 that Initial Operational Release¹⁸ was planned for October 2006, with full Operational Release¹⁹ expected in mid 2007. Defence advised the ANAO in December 2006 that:

¹⁷ The incentive payment reduced by \$0.25 million for each week that delivery occurred after this date.

¹⁸ Initial Operational Release is defined by Defence as the milestone at which Navy is satisfied that the operational and materiel state of the equipment, including deficiencies, training and supportability elements, are such that it is safe to proceed into Naval Operational Test and Evaluation.

¹⁹ Operational Release is the milestone which represents the in-service date, at which, Navy is satisfied that the equipment is safe and fit for operational service and that its current operational capability has been clearly defined.

At acceptance what was actually accepted were the modification work packages to the base ship, not the ship itself. The incomplete test and evaluation activities related solely to these modification packages and at no fault of the Contractor, the Contractor could not complete the required test at that time. The DMO had directed the Contractor not to conduct a small number of tests until a later date to harmonise Tenix's work with that of other contractors working on the ship at the same time.²⁰... Also to be fair and equitable to Tenix, any test or evaluation that was delayed at the direction of the Commonwealth could not legally reduce the Commonwealth obligation to pay the early delivery bonus of \$750 000 to Tenix.

22. The Modification Contract provided for any potential liquidated damages to be available for payment to DMO at two of the original 14 contract milestones. The milestones were for the Critical Design Review and Acceptance. As at Contract signature on 15 March 2005, the Critical Design Review milestone date was 15 July 2005. The Critical Design Review milestone was not submitted for final DMO acceptance until 8 May 2006. Defence has advised the ANAO that the slippage in Critical Design Review approval was due to the DMO seeking the assurance of an expert third party regarding the integrity of Structural Design Analysis. Against the revised milestone date for the Critical Design Review of 15 September 2005, 235 days of liquidated damages at \$7 000 per day, or \$1.65 million in total, was available as a debt payable to the Commonwealth.²¹ Under the Contract, the early delivery of the modified vessel on 7 August 2006 reduces the amount of accrued liquidated damages to \$1.38 million. Defence advised the ANAO in December 2006 that the DMO is assessing the circumstances surrounding the Commonwealth's right to liquidated damages, including seeking legal advice.

23. The new fleet oiler Modification Contract required that the Prime Contractor deliver the final Safety Case Report to DMO by 15 October 2005, 11 months prior to anticipated delivery of the modified ship. The DMO advised the ANAO in August 2006 that elements of the Safety Case Report

²⁰ Defence advised that an example of why the Government directed a change to the testing procedures relates to the ship's sewage treatment plant. The new system was fully tested to the manufacturers standards but could not be fully completed until the full ship's crew were on board and the ship was at sea with the normal motions of a vessel underway.

²¹ Section 47 of the *FMA Act* requires that a Chief Executive must pursue recovery of each debt for which the Chief Executive is responsible unless:

- the debt has been written off as authorised by an Act;
- the Chief Executive is satisfied that the debt is not legally recoverable; or
- the Chief Executive considers that it is not economical to pursue recovery of the debt.

relating to the major work packages were complete but that the Safety Case Report²² would not be finalised until February 2007. It is desirable, from a risk management perspective, that Safety Cases for major capital assets are finalised to schedule so that system hazards are adequately identified and any exposures managed to acceptable levels.

24. Defence advised the ANAO in December 2006 that:

The safety baseline for this ship, as required to meet the Navy safety framework, comprised the Tenix Safety Case Report, the Rexroth Safety Case Report and the Lloyds Register certificate suite provided with the base ship. This suite of documents has met the Navy's safety requirements as demonstrated through Chief of Navy granting Initial Operational Release after careful consideration of, amongst many other things, safety compliance. The Whole Ship Safety Case Report is an initiative of the Project to enhance through life support of the ship. This report seeks to consolidate all other safety case reports and documentation so as to provide a comprehensive configuration baseline for in-service management of the ship. By capturing the design intent contained in these reports, the overall integrity of the design can be maintained and configuration changes can be embodied in accord with this design integrity. The Navy safety framework does not require this to be in place for Initial Operational Release but it is certainly required for full Operational Release, which is expected to be granted mid 2007. The Whole Ship Safety Case Report will be finalised by February 2007.

25. The ANAO notes that the Naval Operational Test and Evaluation Manual²³ (ABR 6205) does not align with the framework outlined above with regard to the Safety Case. This may therefore create misleading expectations of what capability is required at the milestone of Initial Operational Release. The Navy manages gaps in the safety framework by placing limitations on the vessel's operations to effectively manage the relevant capability risks. Generally such risks are managed through limiting the operational use of the vessel.

²² The HMAS SIRIUS Safety Case Report (SCR) is to consist of the following five parts: Part 1: Introduction; Part 2: Capability Description; Part 3: Formal Safety Assessment; Part 4: Safety Management System; and Part 5: Emergency / Contingency Plan.

²³ The Naval Operational Test and Evaluation Manual (ABR 6205) notes that:

The Initial Operational Release process must ensure that all safety aspects are addressed and that at the appropriate milestones it is demonstrably safe to proceed to the next stage of the process. The Materiel Certification Plan is a key document used to support this process. A documented Safety Case will be required for Initial Operational Release.

Overall audit conclusions

26. The Defence Capability Plan 2001–2010 initially proposed that the replacement for WESTRALIA be introduced into service by 2009. With the release of the revised Plan 2004–2014 in early November 2003, Defence formally brought forward the retirement of WESTRALIA to 2006. To achieve this revised timetable, DMO developed and implemented an acquisition approach to advance the delivery of a replacement vessel for WESTRALIA by purchasing a commercial off-the shelf product tanker.

27. In less than three months from Government approval of the Project in March 2004, the DMO successfully completed the identification, evaluation and purchase of an existing product tanker that was suitable for modification to fulfil the role as the Navy's new fleet oiler. The ANAO notes that the capability is likely to be delivered within the approved Project budget, which was reported by DMO as \$143 million in May 2006.

28. The modified vessel was delivered by the Prime Contractor and contractually accepted by DMO five weeks ahead of schedule on 7 August 2006, following which the vessel was commissioned as HMAS SIRIUS on 16 September 2006. The ANAO notes that at the time of delivery of the vessel, contractual deficiencies identified by the Prime Contractor included incomplete and untested modification work. At the time of delivery and acceptance, the Report of the Material and Equipment Performance State for the contracted work noted that the Commonwealth had not identified any issues of concern. DMO advised that it considered that a number of the deficiencies related to the late delivery of Government Furnished Materiel, which was outside the control of the Prime Contractor.²⁴

29. The ANAO observed weaknesses in the administrative processes associated with the financial arrangements implemented by Defence and DMO, which included requirements under both the Commonwealth Financial Framework and the GST legislation. With respect to the Commonwealth Financial Framework, administrative weaknesses included adherence to the provisions for: public funds to be deposited into and held in Official bank

²⁴ Defence advised the ANAO in December 2006 that:

In the period leading up to Tenix offering delivery of the five capability packages, a number of other contractors and Defence agencies were conducting parallel activities onboard the ship. A number of these parallel activities presented minor conflicts with Tenix's activities leading the Project to direct Tenix to defer a number of test and acceptance activities to a later date. In many cases testing had already been completed and witnessed by Commonwealth personnel and the issue was simply one of completing and rendering reports.

accounts; the prompt banking of public funds; and the requirement for authority to be given for the receipt and custody of public funds by non-public servants. Also, improvements were required in the processes to ensure there is a valid authorisation to approve payments from public funds and to debit amounts against an appropriation.²⁵

Agency response

30. The Department of Defence provided a response (see Appendix 1) on behalf of the DMO and Defence. Defence agreed with the recommendation made in this report. The Defence response stated that:

Project SEA1654 Phase 2A (HMAS WESTRALIA Replacement) has provided Defence with an unprecedented opportunity to demonstrate the successful application of Kinnaird Review principles. The DMO has applied innovative techniques to the solution of a complex problem and met, or exceeded, all capability, safety, budget and schedule requirements.

Innovation in this Project has included the use of commercial standards (classification society rules) where appropriate, commercial contracting templates and contracting incentive arrangements. This has resulted in achievement of the desired capability ahead of schedule and within budget.

The DMO's business-like approach to the use of different methods of contracting has been vindicated. The DMO continues to be innovative and look for the best contracting method based on the risk profile of each project. In this case, knowing that there would be obstacles if our identity as a government organisation was disclosed, we decided to purchase the vessel on the open market using a standardised commercial contract format that met all international standards. The DMO then continued to be innovative by leasing the vessel back to the market while it undertook the competitive tender process for the refit activity.

In this Project, the DMO was highly responsive to Government. The requirement under the original Defence Capability Plan was for a vessel to be delivered in 2009 and a project budget of about A\$450 million. That plan was substantially revised by Government following the Defence Capability Review (November 2003). Changes to international regulatory standards have led to an accelerated timetable for the withdrawal of single hull oil tankers like WESTRALIA. Although warships are not strictly bound by these regulations, the environmental impacts and the risk of limited future access to international

²⁵ An appropriation is defined in the Department of Defence Annual Report 2005–06 as an authorisation by the Parliament to spend money from the Consolidated Revenue Fund (the principal working fund of the Commonwealth) for a particular purpose.

waters were key factors in the Government decision to bring forward the replacement of WESTRALIA from 2009 to 2006.

The Project has also been an excellent example of achieving results in partnership with industry. The contract for the refit and modification of the tanker was awarded to Tenix, with the majority of work completed in Western Australia. The contract included incentives for completing the work ahead of schedule. Over a period of 18 months, and with a number of difficult issues to resolve along the way, Tenix completed the work on budget and have received incentives for completing the work ahead of schedule.

Defence regrets that it might be inferred from this report that there are shortcomings in the safety program. Any such suggestions have now been proven baseless through a rigorous test and evaluation process. The delivery of safe capabilities and the safe operation of those capabilities in service is an absolutely key focus for Defence.

Recommendations

Set out below is the ANAO's recommendation, with the report paragraph referenced and an indication of the Defence and DMO response. The recommendation is discussed at the relevant part of this report.

**Recommendation
No. 1**

Para 3.49

The ANAO recommends that where DMO:

- (a) seeks to enter commercial transactions that are unusual or complex, it conduct a higher level of analysis and / or obtain appropriate counsel to ensure these transactions specifically comply with the Commonwealth Financial Framework and the Goods and Services Tax legislative requirements; and
- (b) enters contractual arrangements which provide for public monies to be held in a separate bank account, that account should be established as an Official Account in accordance with the requirements of Section 9 of the *Financial Management and Accountability Act 1997*.

Defence and DMO response: Agreed (a) and (b)

Audit Findings and Conclusions

1. Introduction

This chapter examines the Defence capability planning for the replacement of HMAS Westralia and the current support arrangements for Defence's Amphibious and Afloat Support capability.

Background

1.1 The capability for afloat support comprised the tanker, Westralia, until September 2006 and the replenishment ship, HMAS SUCCESS, and is commonly referred to in Defence as the Maritime Operations Support Capability. The new vessel to replace WESTRALIA is called HMAS SIRIUS and was commissioned by Defence in mid September 2006, which was concurrent with the formal decommissioning of WESTRALIA.

1.2 WESTRALIA is a key element of the Navy's Maritime Operations Support Capability. Launched in the United Kingdom in 1975, WESTRALIA entered service with the British Royal Navy in September 1979, as a fleet support oil product tanker. WESTRALIA was leased by the Navy in class in 1989, and then purchased by Navy in 1994.

1.3 The Defence White Paper 2000 (the 'White Paper') identified the requirement to replace WESTRALIA and SUCCESS upon their anticipated retirements from service in 2009 and 2015 respectively. The White Paper noted that WESTRALIA was to be replaced with a purpose-built support ship. SUCCESS was to be subsequently replaced with another replenishment ship of the same class.

1.4 Defence reported that the shortcomings of WESTRALIA's capability included:

- limited facilities and the inability to land on the flight deck aft means a reduced aviation capability that degrades afloat support effectiveness;
- the ship's maximum speed (16 knots) prevents full integration into any task group that requires flexibility by operating at higher speeds; and
- a command and control system that lacks the ability to integrate with a task group.

Project SEA 1654

1.5 The Defence Capability Plan (DCP) 2001–2010 identified Project SEA 1654 to replace the existing Navy afloat maritime operations support capability. The DCP also restated the 2000 Defence White Paper preference to build the replacement ships in Australia.

1.6 In accordance with the DCP 2001–2010, Project SEA 1654 was to be delivered in three phases:

- **Phase 1** involved the conduct of a Project Definition Study to identify the options for replacing the current afloat support capability. The DMO Project Definition Study was to provide detailed planning for the Phase 2 replacement of WESTRALIA and Phase 3 replacement of SUCCESS acquisitions.
- **Phase 2** was to involve the replacement of WESTRALIA with a purpose-built support ship when WESTRALIA reached the end of its design life. The ship was to be in-service before 2009 at an estimated expenditure of \$350 to \$450 million.
- **Phase 3** was to involve replacement of SUCCESS with a purpose-built support ship when SUCCESS reached the end of its design life. The ship was to be in-service before 2015 at an estimated expenditure of \$350 to \$450 million.

1.7 Following a strategic review of the existing DCP in 2003, Defence announced major changes to the scope and schedule of the unapproved elements of Project SEA 1654.

1.8 The DCP 2004–2014 stated that Project SEA 1654 Phase 2A would involve WESTRALIA being replaced through the acquisition of another operating but environmentally sustainable ship of commercial origin. The replacement ship was to be modified in Australia to provide the fleet with underway replenishment of fuel (diesel and aviation) and water. The then Minister for Defence announced in November 2003 that, to help offset the costs of larger amphibious ships, Project SEA 1654 Phase 2A was a less ambitious replacement of WESTRALIA than that envisaged by the White Paper.

1.9 Following the Defence Capability Review in November 2003, the DMO's Project SEA 1654 Phase 2A (hereafter known as the 'Project') was fundamentally changed. The Project was to no longer deliver an Auxiliary Oiler Replenishment capability based on a purpose-built design. The notional Project budget was reduced from between \$350 and \$450 million to between

\$100 and \$150 million. Within the revised budget, Defence was to acquire a commercial second hand Auxiliary Oiler and modify it in Australia.²⁶ Table 1.1 summarises the revised objectives, key dates and forecast expenditure of Project SEA 1654.

Table 1.1

Defence Capability Plan 2004-2014: Project SEA 1654

Phase	Description	Year of Decision	In-Service Date	Estimated Expenditure
2A	Replacement of WESTRALIA with a commercial second hand Auxiliary Oiler which will be modified in Australia	2003–04	2005–07	\$100m to \$150m
2B	Provide a new oiler as the WESTRALIA replacement reaches the end of its life. The replacement ship will comply with impending international conventions and regulations governing marine hull design.	2014–17	2018–20	\$150m to \$200m
3	Replacement of HMAS SUCCESS with a purpose built support ship when it reaches end of service life.	2011–14	2015–17	\$350m to \$450m

Source: DCP 2004–2014, November 2003.

1.10 In June 2006, Defence released the DCP 2006-2016. Under the DCP 2006–2016, Defence cancelled Project 1654 Phase 2B and increased the funding available for Project 1654 Phase 3, the replacement of HMAS SUCCESS, to between \$450 and \$600 million.

International Maritime Organisation Regulations

1.11 The MARPOL Convention is the main international convention covering the prevention of pollution of the marine environment by ships from operational and accidental causes. First proposed in November 1973 by the International Maritime Organisation (IMO), the MARPOL Convention sought to cover pollution by oil, chemicals, harmful substances in packaged form, sewerage and garbage. The 1973 MARPOL Convention was not ratified at the

²⁶ DMO advised the ANAO in August 2006 that the achievement of a 2006 delivery was also important as extending WESTRALIA beyond mid 2006 would have resulted in expenditure in the order of \$4 million to maintain the vessel in class.

time, and it was not until after a series of tanker accidents in 1976 and 1977 that the IMO held a conference on tanker safety and pollution prevention in February 1978. This conference established and adopted what has become known as the 1978 MARPOL Protocol. MARPOL 73/78 (hereafter referred to as 'MARPOL') entered force in October 1983.

1.12 Australia has been a member of the IMO since 1952 and accordingly, the MARPOL regulations were to be applied to all commercial Australian maritime shipping operations from MARPOL's commencement in October 1983.²⁷ Article 3 of MARPOL provided the following exemption for naval vessels:

The present Convention shall not apply to any warship, naval auxiliary or other ship owned or operated by a State and used, for the time being, only on government non-commercial service. However, each Party shall ensure by the adopting of appropriate measures not impairing the operations or operational capabilities of such ships owned and operated by it, that such ships act in a manner consistent, so far as is reasonable and practicable, with the present Convention.

1.13 Defence advised the ANAO in June 2006 that the maritime community recognised that the unique requirements of naval vessels were often incompatible with the commercial oriented MARPOL regulations. However, the Navy stated that it makes its best efforts to comply with the spirit and intent of MARPOL providing that this does not adversely impact on the Navy's ability to conduct maritime operations. DMO advised the ANAO in August 2006 that Navy considered they had fully met the IMO obligations when the special conditions concerning warships were taken into account.

1.14 At the time of its ratification in 1978, member countries had only endorsed Annexes I and II of MARPOL. In order to encourage states to become a party to the convention, MARPOL required the immediate implementation

²⁷ MARPOL is accompanied by six annexes which have been progressively introduced:

- Annex I - Prevention of pollution by oil (effective October 1983)
- Annex II - Control of pollution by noxious liquid substances (effective April 1987)
- Annex III - Prevention of pollution by harmful substances in packaged form (effective July 1992)
- Annex IV - Prevention of pollution by sewerage from ships (effective September 2003)
- Annex V - Prevention of pollution by garbage from ships (effective December 1998)
- Annex VI - Prevention of air pollution from ships (effective May 2005)

of Annex I, with Annex II to only become binding on member states three years after the protocol entered into force.²⁸

1.15 In March 1992, new regulations 13F and 13G were added to Annex I. Regulation 13F requires all new tankers of 5 000 tonnes deadweight²⁹ and above to be fitted with a double hull separated by a space of up to two metres. Regulation 13G applies to existing crude oil tankers of 20 000 tonnes deadweight and product carrier of 30 000 tonnes deadweight and above.³⁰ As introduced, Regulation 13G further required that tankers built in the 1970s which are 25 years or older must be converted to comply with the standards set out in Regulation 13F or are to be scrapped.³¹

1.16 In December 2003, the IMO agreed to amend Annex I of MARPOL to bring forward the final phasing-out date of Category 1³² tankers from 2007 to 2005. The final phasing-out date for Category 2³³ and 3³⁴ tankers (MARPOL tankers and smaller tankers) was also brought forward from 2015 to 2010.

DMO chartering of the of the DELOS

1.17 Prior to the purchase of the DELOS, DMO examined options for its interim operation and upkeep prior to its anticipated handover for the planned modification program. DMO identified that the primary objective to be achieved in the interim period was the completion of the design package for

²⁸ The delayed introduction of Annex II was to give member states time to overcome technical problems in Annex II, which had been a major obstacle in ratifying the 1973 Convention.

²⁹ Dead weight tonnage (DWT) is the total weight of the ship, fuel, water, engine stores and cargo.

³⁰ Under Regulation 13G, tankers that were 25 years old and which were not constructed according to the requirements of the 1978 Protocol to MARPOL have to be fitted with double sides and double bottoms. The Protocol applies to tankers ordered after 1 July 1979, which were begun after 1 January 1980 or completed after 1 June 1982.

³¹ The April 2001 amendment to MARPOL permits flag state administrations to allow some newer single hull ships registered in its country, that conform to certain technical specifications, to continue trading until the 25th anniversary of their delivery. The amendment also permitted any port state to deny entry of those single hull tankers, which are allowed to operate until their 25th anniversary, to their ports and offshore terminals.

³² The IMO designates Category 1 oil tankers to be of 20 000 tonnes deadweight and above carrying crude oil, fuel oil, heavy diesel oil or lubricating oil as cargo, and of 30 000 tonnes deadweight and above carrying other oils, which do not comply with the requirements for protectively located segregated ballast tanks (commonly known as pre-MARPOL tankers).

³³ IMO designates Category 2 oil tankers to be of 20 000 tonnes deadweight and above carrying crude oil, fuel oil, heavy diesel oil or lubricating oil as cargo, and of 30 000 tonnes deadweight and above carrying other oils, which do comply with the requirements for protectively located segregated ballast tanks (commonly known as MARPOL tankers).

³⁴ IMO designates Category 3 oil tankers to be of 5 000 tonnes deadweight and above but less than the tonnage specified for Category 1 and Category 2 tankers.

the modification of the DELOS. Respondents to the tenders for the design and modification work packages were to be provided with access to the DELOS.

1.18 DMO advised the then Minister for Defence in late July 2004 that DMO had entered into a time charter contract for the commercial charter of the DELOS to Teekay Shipping Singapore Pty Ltd at a daily rate of US\$15 000 per day. The time charter contract was established with Teekay Chartering Limited of the Marshall Islands (referred to as 'Teekay Chartering'). DMO advised that the DELOS charter contract commenced on 24 June 2004 for a period of six months with estimated operating costs of US\$14 000 per day.

1.19 An outline of the financial and management arrangements for the chartering of the DELOS, which involved charter proceeds of \$8.22 million, are detailed in Figure 1.1. The Defence Tax Management Office reported in July 2006 that Teekay Marine belongs to a group of companies where all accounting transactions are recorded in the accounts of the head company Teekay Shipping Pty Ltd.³⁵

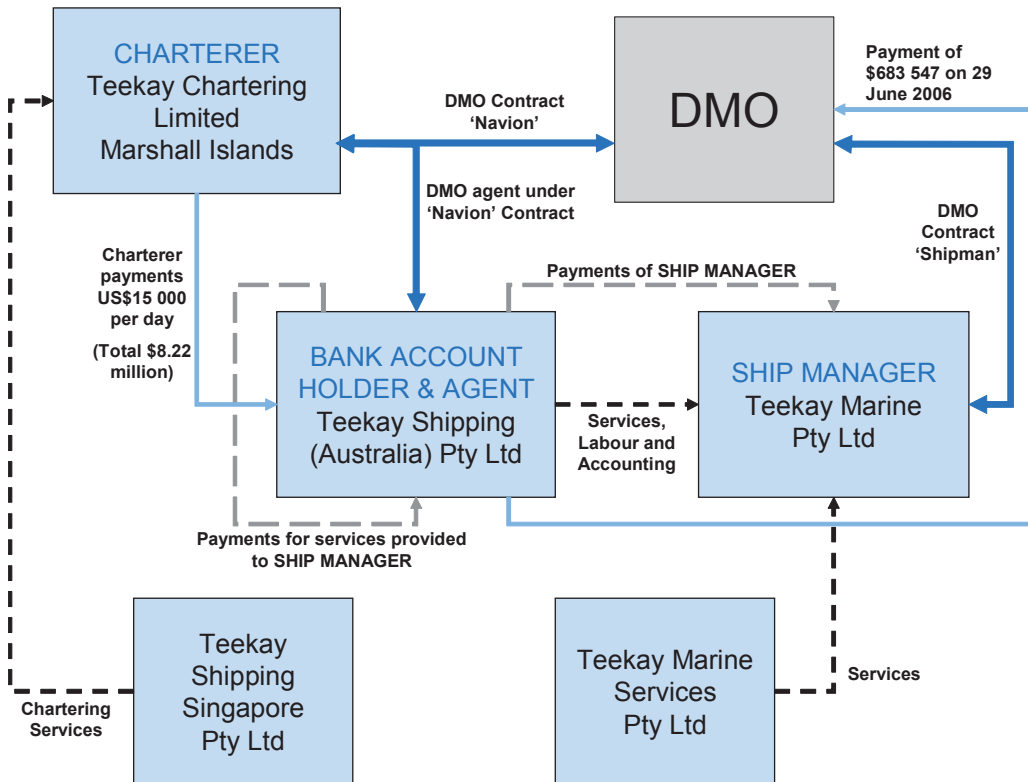
³⁵ DTMO further reported in July 2006 that other companies in the group are:

- **Teekay Marine Pty Ltd** (hereto referred to as 'Teekay Marine') – provided management of the DELOS and its associated costs during the commercial phase;
- **Teekay Shipping (Australia) Pty Ltd** (hereto referred to as 'Teekay Shipping') – provided labour, services, accounting;
- **Teekay Marine Services Pty Ltd** – provided services;
- **Teekay Shipping Singapore Pty Ltd** – commercial chartering of the DELOS; and
- **Teekay Chartering Limited Marshall Islands** – the contracting party regarding the chartering of the DELOS.

Teekay Shipping Pty Ltd's website states that it is incorporated in the Marshall Islands, has its corporate head office in the Bahamas, and its operational headquarters in Vancouver, Canada.

Figure 1.1

Arrangements for the management of the DELOS during the commercial charter period (June 2004 to August 2005)



Source: ANAO analysis of DMO and Defence records.

Amphibious and Afloat Support System Program Office

1.20 The Amphibious and Afloat Support System Program Office (AASSPO) is the DMO System Program Office (SPO) responsible for the in-service maintenance and sustainment of Defence's amphibious and afloat support capabilities.³⁶ AASSPO advised the ANAO in January 2006 that its budget for 2005–06 was \$69 million.

1.21 The sustainment services provided by DMO are required to support Navy activities and known national taskings that are detailed in Defence's Platform Availability Plan, as well as to meet its agreed Joint Operations

³⁶ These capabilities correspond to Defence Output 2.7 Capability for Amphibious lift and Output 2.5 Capability for Afloat Support. As at January 2006, the amphibious and afloat support capability sustained by AASSPO included HMAS WESTRALIA, HMAS SUCCESS, HMAS TOBRUK, HMAS MANOORA and HMAS KANIMBLA, six Landing Craft Heavy vessels and a number of smaller amphibious craft.

Command Operation Preparedness Requirement (including contingencies) and Organisational Performance Agreement obligations.

1.22 DMO has extended the current Teekay support services contract [Shipman Contract] for SIRIUS until March 2007. Between August 2006 and March 2007, the In-Service Support Contract for HMAS SIRIUS will be evaluated, negotiated and agreed.

1.23 AASSPO is planning to commence a program of major re-fit work on HMAS SUCCESS in January 2007. This work is planned to commence after HMAS SIRIUS is transitioned into service, meaning that Defence should maintain its agreed Directed Level of Capability (DLOC) obligation to Government.³⁷ The major re-fit program for HMAS SUCCESS is scheduled for completion by mid-2007 at a cost to Defence of approximately \$40 million.

Audit approach

1.24 The audit reviewed the planning, approvals, project management and financial management of the Project to replace WESTRALIA. The audit addressed the delivery processes of the Project, with specific regard to contract management and capability delivery. As such, this was not an audit of contractor performance, but of the formation and contract management of the acquisition project by DMO.

1.25 ANAO fieldwork was conducted between September 2005 and August 2006, which included visits to the vessel modification site in November 2005 and April 2006. A Position Paper on the Financial Management of MT DELOS Hiring was provided to DMO in March 2006. Four Issues Papers were provided to Defence and DMO in May 2006. A Discussion Paper was provided to Defence and DMO in July 2006, followed by a Draft Report in November 2006.

1.26 The audit was conducted in accordance with ANAO Auditing Standards at a cost to the ANAO of \$485 000.

Report structure

1.27 The remainder of this report is structured into three chapters. Chapter 2 outlines the Project's approvals processes and the purchase of the DELOS.

³⁷ DLOC agreements establish the levels of capability, which are to be maintained to meet preparedness, ongoing operations, Defence international engagement program tasks and known national task requirements within financial guidance. The agreement is the level of capability at which the organisation is funded and resourced.

Chapter 3 discusses the commercial chartering of the DELOS and the adherence of those arrangements with the Commonwealth Financial Framework. Chapter 4 examines the cost and schedule performance of the program to modify the DELOS for Navy use.

2. Project Approval and Ship Purchase

This chapter examines the Project's planning and approvals process, including the purchase of the DELOS.

Background

2.1 Under MARPOL, WESTRALIA was originally classified as a Category 1, single hull tanker. Launched in 1975 and delivered into British Royal Navy service in 1979, WESTRALIA reached the 25-year operational milestone in September 2004 (see paras 1.11 – 1.16).

2.2 In the absence of the double hull conversion work (specified under MARPOL Regulation 13G in March 1992)³⁸ WESTRALIA would have become non-compliant with the equivalent commercial vessel requirements from late September 2004. Defence reported in June 2002 that its intention to cease using WESTRALIA's wing tanks for the carriage of oil products after 25 years from delivery would enable WESTRALIA to remain in service until 2006 and still comply with the MARPOL regulations.

2.3 Regulation 13G was amended in December 2003 such that all equivalent commercial Category 1 tankers were to be phased out by early April 2005. Although designed to bring forward the phasing-out of many newer Category 1 tankers, this amendment actually extended WESTRALIA's ability to comply with Regulation 13G from September 2004 to April 2005.

2.4 WESTRALIA was reclassified by the Lloyd's Register Classification Society as a Category 3 tanker in late 2004. This was achieved by issuing new loadline and tonnage certificates to reduce WESTRALIA's registered deadweight tonnage to 29 999 tonnes, under the 30 000 tonne threshold for Category 1 and 2 tankers. In accordance with the Category 3 classification, WESTRALIA would need to be retired from Navy service by the end of 2006 to achieve compliance with Regulation 13G in line with equivalent commercial Category 3 tanker requirements.

2.5 Australian naval ships are not obliged to comply with IMO conventions. However, the Navy stated that it makes its best efforts to comply with the spirit and intent of MARPOL providing that this does not adversely impact on the Navy's ability to conduct maritime operations. Prior to

³⁸ This required that tankers built in the 1970s and 25 years or older must be converted to comply with the new vessel standards.

November 2003, official Defence guidance planned to introduce the replacement capability for WESTRALIA in 2008–09. Strict compliance with Regulation 13G, as it was introduced in March 1992, would have initially required WESTRALIA (in its original classification as a Category 1 tanker) to be retired from service before September 2004, with a replacement introduced into service around that time.³⁹

2.6 Defence's management strategy for WESTRALIA has been highly adaptive to recent MARPOL developments in that it has extended WESTRALIA's operational life to over 27 years, and will maintain class certification and MARPOL compliance until retirement in late 2006.⁴⁰ These measures should also ensure that there will be no capability gap risks associated with the replacement of WESTRALIA. The timeline of key events relevant to the purchase of the DELOS is illustrated in Table 2.1.

³⁹ The DMO advised the ANAO that it considered that Defence planning did take into account the introduction of MARPOL in that it had utilised the exemption for any warship, naval auxiliary or other ship owned and operated by a State and used only on government non-commercial service.

⁴⁰ The ANAO notes that the April 2001 amendments to MARPOL permit all States to deny entry of non-compliant but otherwise exempt commercial service ships to its ports and offshore terminals. On 11 January 2005, the Australian Maritime Safety Authority notified the IMO that all commercial service vessels of the type and classification of WESTRALIA, that were operating under the exemptions available to and exercised by State administrations, would be denied entry to Australian ports from 5 April 2005.

Table 2.1**Key events relating to the purchase of the DELOS**

Date	Event
1992	MARPOL regulations introduced requiring the new tankers to be double hull and old tankers to be converted to the same design standards or to be scrapped after reaching their 25 year anniversary.
1994	Purchase of WESTRALIA from Royal Navy which had been under lease from the Royal Navy since 1989.
2000	Defence White Paper identified the requirement to replace WESTRALIA with a purpose built support ship.
September 2003	Defence Procurement Review (Kinnaird Report).
November 2003	Defence Capability Plan 2004–2014 redefines scope, budget and schedule of the WESTRALIA Replacement Project.
December 2003	MARPOL amendment requiring commercial vessels of the same size, type and age as WESTRALIA (as reclassified as a Category 3 tanker) to be removed from service by 2006.
January 2004	Contractors engaged by DMO to assist with base ship identification and design suitability.
March 2004	Government Approval of Project.
May 2004	Approval to purchase the DELOS.
June 2004	Purchase of the DELOS.

Source: ANAO analysis of DMO records and MARPOL regulations.

Kinnaird Report - strengthened two-pass approval system

2.7 In November 2002, the Vice Chief of the Defence Force endorsed the Defence Capability Systems Life Cycle Management Manual (the ‘Manual’) as Defence’s principal reference document for capability development and management. The Manual sought to emphasise the management of the front end of the life cycle, especially the management of Major Capital Investment projects. Defence advised the ANAO that it considered that the Manual was Departmental guidance, not policy, and accordingly strict compliance was not mandated.

2.8 The Manual outlined that, during the requirements phase of major capital investment projects, Defence was to involve formal Government consideration of future capability on two occasions, known as first-pass and the second-pass approval, with the latter being the most important as it seeks Government approval to proceed with capital investment. The guidance also

stated that the two-pass approach was designed to ensure that Government was able to exert early influence over Defence's major capital investment program.

2.9 The Kinnaird Report on the Defence Procurement Review was released in September 2003. The Report recommended that: Government should mandate, and reinforce via revised Cabinet rules, a rigorous two-pass system for new acquisitions with government considerations dependent on comprehensive analysis of technology, cost (prime and whole-of-life) and schedule risks subjected to external variation. The Kinnaird Report also stated that, in relation to the Manual:

Currently, capability definition and assessment notionally follows a two-pass system. However, as it is currently practiced, the system lacks rigour and discipline and it appears that there is, on occasion, disagreement on what constitutes the process at each stage. It is also not based on mandatory endorsement of key decisions by relevant stakeholders, nor is external scrutiny applied to significant aspects of the proposals being forwarded to Government.

The system has not been well communicated to all relevant stakeholders despite being detailed in the Defence Capability Systems Life Cycle Management Manual 2002. Importantly, the major processes described in the Manual are not embodied in the formal Cabinet arrangements as a set of endorsed rules on how Defence should bring forward capability proposals to Government.

2.10 Defence advised the ANAO in May 2006 that the Manual permitted, where a Major Capital Investment project was included in years zero to four of the DCP, as a result of Government direction, even though a Capability Requirements Business Case⁴¹ had not been developed, it was considered as

⁴¹ The Capability Requirements Business Case was to, at a minimum, include the following details:

- the capability gap to be reduced;
- the proposed Year of Decision and in-service date;
- an estimate of the likely cost band;
- a brief description of generic options for reducing the capability gap;
- the generic options recommended for exclusion;
- the generic option(s) to be developed further;
- how industry will be engaged in the preparation of the Acquisition Business Case;
- the identification of any implications for strategic industry capabilities; and
- the planned date for second-pass to Government and the possible need for additional Government consideration.

having first-pass approval. The Project's revised scope was identified in the DCP 2004–2014, which was released in November 2003. The DCP 2004–2014 stated that the revised Project would have a 2003–04 year of decision.

2.11 Second-pass approval involves formal Government approval for: Defence to seek formal offers from suppliers that lead to the selection of a materiel or facilities solution; and agreement to the boundaries of the preferred solution, especially in terms of capability, costs and schedule. Second-pass approval by Government is the key element of Project Approval.

2.12 In releasing the revised DCP 2004–2014 in November 2003, the then Minister for Defence announced that it was the Government's intention that all capabilities set out under the DCP would be progressed in line with the reforms proposed in the Kinnaird Report, subject to transitional arrangements. These reforms were announced to include: measures to strengthen the capability development and assessment process; improve project delivery; strengthen the two-pass system; provide a better basis for project scope and cost; and give greater recognition to the importance of managing through-life support for capabilities.

2.13 The September 2003 Defence Procurement Review proposed that, pending the full implementation of the two-pass approval system, Government's consideration of the November 2003 DCP could constitute first-pass approval of projects contained there within. In early March 2004, Government agreed with this proposal such that DCP projects with a 2003–04 or 2004–05 year of decision, which included this Project, would progress directly to second-pass consideration. The two-pass approval system was to be fully implemented for projects with a 2005–06 year of decision or later.

2.14 Defence and DMO advised the ANAO that the Kinnaird strengthened two-pass approval system arrangements were finalised in early 2005 and were promulgated as formal direction via the Defence Capability Development Manual 2006.⁴² Defence and DMO subsequently advised the ANAO that the strengthened two-pass approval system requirements are continuing to evolve.

⁴² DMO advised the ANAO in mid 2006 that, in response to the September 2003 Kinnaird Report, the:

... process revamp draft [was] not produced until May 2004 (post second pass approval for Project SEA 1654 Phase 2A) and finalised / promulgated until late 2004 / early 2005 and only widely promulgated as formal direction via the Defence Capability Development Manual 2006.

Project approval

2.15 Following the Defence Capability Review in late 2003, DMO identified that the revised schedule for acquiring new major warships would require a departure from current processes. In October 2003, DMO advised the then Minister for Defence that its usual acquisition approach could not be completed within the revised DCP timeframes, and that it intended to adopt an innovative approach to acquisition that would still ensure that the fundamental requirements of Government procurement policy were achieved.

2.16 The total Project Approval was \$138.0 million (March 2004 prices), of which \$48.0 million was allocated for vessel purchase and \$76 million was allocated for the subsequent vessel modification design and production program.⁴³ The Project Approval acknowledged that an additional \$15 million may be required to deliver the core capability, but that Defence would have to identify equivalent cost offsets within existing budgetary guidance. By January 2006, the approved funding had increased to \$141.7 million due to updates for exchange rate variations and inflation.⁴⁴ This funding was in addition to initial funding of \$1.0 million that was allocated by the Vice Chief of the Defence Force in late November 2003.

Purchase of the DELOS

2.17 In accordance with the DCP 2004–2014, the scope of the Project was changed. Defence and DMO, with the assistance of a number of contractors, sought to identify second hand, less than five years old, commercially operating tankers that would be suitable for conversion to meet Defence-specific requirements.

2.18 At the time of Project initiation in late 2003, the Project produced an Acquisition Cost and Schedule Information document which identified that DMO had conducted a preliminary investigation into the technical feasibility, possible cost and schedule associated with the acquisition and modification of a new to five year old, double hull ship for naval service as a replacement for WESTRALIA. The document stated that the purposes of such an acquisition strategy were:

⁴³ The Project Approval did not specify that the vessel had to be purchased within the 2003–04 financial year.

⁴⁴ This amount was after a \$2.985 million real cost decrease that transferred funding to another DMO major capital project.

- to reduce overall cost by acquiring absolute minimum capability (equivalent to WESTRALIA); and
- to take advantage of a possible budget surplus in the current financial year.

2.19 Defence capability guidance prior to November 2003 required that the replacement for WESTRALIA was to have a higher operating speed than that of WESTRALIA, which was 16 knots.⁴⁵ Defence advised the ANAO that the decision in November 2003 to pursue a commercial tanker as the base ship meant that the original capability objective had to be lowered to 14 knots.⁴⁶ Alternative ship designs that may have permitted higher operational speeds, such as container ships, were eliminated from consideration at an early stage as their subsequent modification was considered a high risk in terms of Australian industry ability, cost and schedule. Defence advised the ANAO in December 2006 that HMAS SIRIUS has demonstrated the capability to achieve speeds of more than 16 knots.

2.20 DMO reported in late 2003 that the Vice Chief of the Defence Force had approved initial funds of \$1.0 million to conduct a search for a base ship capable of being modified to meet the endorsed essential capability. It was anticipated by DMO that Ship Agent and Ship Design Consultant services would be required.

2.21 The major contractors in this Project phase performed the roles of: Ship Design Consultant; Project Assurance Advisor; Legal Advisor; International Classification Society; Shipbroker;⁴⁷ and Commercial Tanker Operations Consultant and Ship Agent (Teekay Shipping). The approved roles of the major contractors during the ship selection and purchasing phase, as well as the total associated payments, are identified in Table 2.2. Defence advised the ANAO in December 2006 that Defence at all times had the lead in ship search, selection and purchase activities. Contractors provided expert advice but did not lead activities.

⁴⁵ Defence advised the ANAO in February 2006 that:

The initial speed requirement was lowered simply because of budget vs available ships. This does have an operational impact as it clearly lowers the speed at which a task group with embedded Auxiliary Oiler can proceed. In turn this makes the task group more vulnerable particularly to submarines, which is why the SEA 1654 target speed was initially around 20+ knots.

⁴⁶ Defence advised the ANAO in February 2006 that tankers are generally designed to cruise at around 14.5 knots.

⁴⁷ DMO did not have a contractual relationship with the Shipbroker, nor did it make any direct payment for the services it provided. DMO advised the ANAO in late August 2006 that the Shipbroker, as the DMO's broker, was paid a commission by the seller of the ship, which is the normal commercial practice. DMO advised the ANAO that it was not aware of the amount of the commission received by the Shipbroker.

Table 2.2**Expenditures of significant contractors during the ship selection and purchasing phase: November 2003 to June 2004**

Contractor	Approved Scope of Work and Deliverables	Total DMO Payments
Ship Design Consultant	<ul style="list-style-type: none"> Auxiliary Oiler Base Ship Specification Preliminary List of Modifications^(a) Long Lead Item Specifications Ship Survey Reports Ship Survey Summary Base Ship Modification Specifications 	\$160 798
Project Assurance Advisor	<ul style="list-style-type: none"> Base Ship Acquisition Document Assessment Project Safety Checklist Candidate Inspection Checklist Candidate Ship Assessment Reviews Capability Investment Submission Review Base Ship Modification Specification Review 	\$80 790
Legal Advisor	<ul style="list-style-type: none"> Legal advice to Project 	\$94 887
International Classification Society	<ul style="list-style-type: none"> Not contracted to the Commonwealth 	\$0
Shipbroker	<ul style="list-style-type: none"> Not contracted to the Commonwealth 	\$0
Commercial Tanker Operations Consultant and Ship Agent	<p><u>Part 1</u>^(b)</p> <ul style="list-style-type: none"> Identify ships that would represent value for money. Produce a shortlist of 2-6 ships. Provide a report on each ship Obtain relevant technical documentation. Assist Defence and DMO review the short listed ships. Write a report detailing the outcomes of the tasks specified above including a purchase recommendation. <p><u>Part 2</u></p> <ul style="list-style-type: none"> Inspect and report on Preliminary Candidate Ships. Facilitate Defence and DMO inspections of the ships. Co-develop the Negotiation Directive with DMO. Facilitate the ship purchase through the Shipbroker. Conduct / report on the joint Due Diligence Inspection with Defence and DMO. 	<p>\$52 137</p> <p>^(c)\$199 081</p>

Notes: (a) Significant estimated modification costs included those for the hull structure (\$3.0 million), replenishment at sea systems (\$15.8 million), superstructure and accommodation (\$4.5 million), helicopter operations facilities (\$4.8 million), and painting (\$4.8 million).

- (b) DMO advised the then Minister for Defence in March 2004 that Teekay Shipping was contracted on 23 January 2004 to act as Shipbroker surveying relevant tanker markets and advising on the likely risk and costs of procurement of a suitable tanker.
- (c) Subsequent to the purchase and delivery of the ship to the DMO, the DMO made a payment to Teekay Marine of \$1.336 million on 21 June 2004 to cover due diligence inspections, statutory costs, operating expenses, commissioning project team costs and fuel costs to facilitate the purchased vessel's return to Australia. A Financial Investigation Service report completed in June 2006 concluded that the actual cost incurred was \$714 964 (see also Table 3.2). The \$1.336 million was credited to the Commonwealth's working account and drawn down over the charter period as part of the vessel's operating expenses.

Sources: Relevant DMO Contracts, Contract Approval documentation and Defence's Resources and Output Management and Accounting Network (ROMAN) expenditure records for Contract work completed between January and June 2004.

Selection of the DELOS

2.22 Based on the Designer's initial Base Ship Specification and List of Modifications, Project Office contractors conducted a worldwide search of operating tankers to produce a short list of vessels that were compliant with the Base Ship Specification; were capable of modification to meet Navy operational requirements; and were available for purchase.⁴⁸

2.23 A report produced in April 2004 short listed six vessels for further evaluation.⁴⁹ The report proposed that, in order to conduct a more detailed engineering, technical and commercial assessment of the selected vessels, physical inspections and surveys would have to be conducted. The report's recommendation was that the next phase of the Project consist of inspections of the short listed candidates, to ensure full compliance with DMO's Base Ship Specification.⁵⁰

2.24 At that time the Project noted that its requirement to ensure that it acquired a suitable ship in that financial year was impacting on the ability of the Designer to undertake further surveys and thus deliver reports. The Project concluded that it no longer considered that surveys of all short listed ships necessary, but that one final comprehensive report on the chosen candidate ship was now essential. The DMO provided the ANAO with clarification in

⁴⁸ DMO advised the then Minister for Defence in March 2004 that preliminary discussions with Teekay Shipping had indicated vessels were available that broadly met the Defence baseline specification. DMO further advised six vessels had been recommended by Teekay Shipping with a median price of US\$35 million.

⁴⁹ The report recommended, based on the Ship Design Consultant's advice, that DMO concentrate on vessels within the 30 000 to 39 000 deadweight tonnage range as it assessed that this was a common design size and provided the widest range of vessels that were closest to the Base Ship Specification.

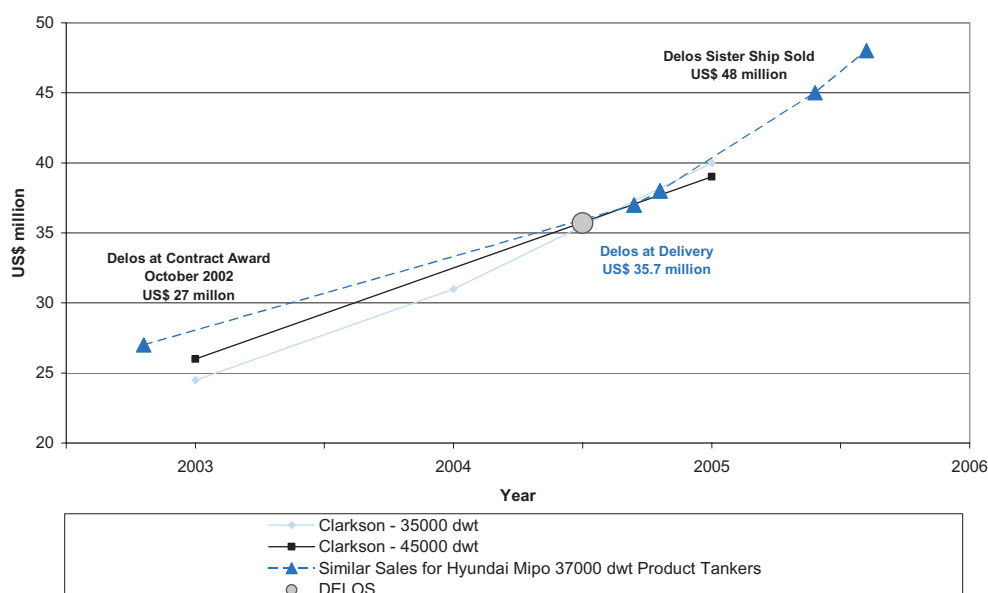
⁵⁰ DMO advised the then Minister for Defence in April 2004 that the final output of the commercial market survey undertaken by Teekay Shipping was a list of six candidate ships that met the technical requirements of the Base Ship Specification.

August 2006 that their guidance at that time was to purchase the ship in the current financial year, if possible. Furthermore, the Project Office had undertaken the design evaluation on a 'generic' 37 000 deadweight tanker, which included an initial design and operational assessment of a domestic oil product tanker that was managed by Teekay.⁵¹ The design assessment report of the generic tanker was finalised on 3 March 2004, with the operational assessment conducted by Navy staff on 9 March 2004.

2.25 DMO provided Figure 2.1 to the ANAO in June 2006 which illustrates that the commercial price for a suitable ship was increasing at that time.

Figure 2.1

DMO analysis in June 2006 of price trends in the relevant product tanker market (2002 to 2006)



Note: Deadweight tonnage is commonly abbreviated as dwt.

Source: Figure provided to ANAO by DMO on 1 June 2006.

Evaluation Report

2.26 DMO produced a Base Ship Selection Evaluation Report in May 2004 which sought to evaluate the suitability of the base ship candidates. The report

⁵¹ DMO also advised the ANAO that one of the key recommendations to come out of the operational assessment was the requirement to gain further operational experience on the purchased vessel in support of the design development phase. DMO advised the ANAO that the requirement to enter a 'time charter' style of ship lease evolved from this recommendation.

identified that size was a significant discriminator in the selection of the base ship, noting that a larger ship (35 000 tonnes deadweight) offered growth and flexibility over the bare minimum essential cargo requirement, whilst a smaller ship (10 000 tonnes deadweight) may represent lower overall cost in delivering a minimum capability requirement.

2.27 DMO evaluated a total of eleven ships which included the four unsolicited proposals that included a specific ship option.⁵² Of those four unsolicited proposals, three were excluded from further consideration on the basis of their inadequate vessel size. The proposed vessel from the remaining unsolicited proposal was progressed for further evaluation alongside the seven other vessels that had been identified by the Shipbroker and Teekay Shipping, based on DMO requirements, as being suitable and available. DMO then reduced this list down to four vessels that would be subjected to a more detailed evaluation.

2.28 A post-purchase report in July 2004 stated that detailed inspections had been conducted on three of the above mentioned short listed vessels, which were conducted by Defence and DMO staff and their contractors.⁵³ At the completion of these inspections and the broader base ship suitability assessment process, two vessels were identified as being most compliant. DMO advised the ANAO in August 2006 that Defence was also responsible for this report's findings and Teekay had the responsibility to compile the individual reports from the Base Ship Inspection Team members into a single trip report.⁵⁴

2.29 The indicative price tag for the DELOS was US\$36 million, US\$3 million more than that estimated for the 2nd Ranked Ship. The July 2004 report stated that this price differential reflected a premium for the purchase of a new vessel. The report recorded that the DELOS had been recommended as the preferred vessel.

⁵² The unsolicited proposals that offered general services rather than a specific ship option were not pursued.

⁵³ The report also reported that four vessels were inspected in this period, including a vessel that was not previously short listed.

⁵⁴ DMO further advised that, for each of the shortlisted candidate vessels, there were reports produced by the Ship Design Consultant, the DMO Project Assurance Advisor, Teekay and the vessels' respective classification societies.

Selection and evaluation criteria

2.30 The DMO's May 2004 Base Ship Evaluation Selection Report detailed the stages of the selection process from initial short listing through to inspection and ranking of suitable vessels. In accordance with the Proposal Evaluation Plan, DMO conducted a detailed analysis of four vessels, which included the DELOS.

2.31 The Proposal Evaluation Plan identified that a tiered set of selection criteria would be used to evaluate suitability of these vessels. The highest level criteria, and scores against these criteria for the DELOS and the 2nd Ranked Ship, are shown in Table 2.3.⁵⁵

2.32 Analysis of the DMO Base Ship Selection evaluation documentation by the ANAO indicated that the evaluation data did not have numerical assessments against the program criterion and its relevant sub-criteria of availability and spend profile. The ANAO analysis concluded that against the program criterion, the DELOS must have received a rating of 5 out of 10, compared to a rating for the 2nd Ranked Ship of 1.7 out of 10. These assessments were reconstructed by the ANAO to achieve the DMO Project Office's Overall Merit Rating assessments (see Table 2.3) for DELOS (6 out of 10) and the 2nd Ranked Ship (5 out of 10).

⁵⁵ The ANAO observed that assessments had been made against the lower level criteria however, from the ANAO's reconstruction of the evaluation results, there was often significant differences between the assessments (against the higher level criteria) and those derived from the initial assessments (against the lower level criteria). Defence advised the ANAO in December 2006 that:

This is often the case. VFM Focus is a useful tool for lower level assessment but strict adherence to its quantitative methodology at higher levels can skew results. Qualitative analysis is more appropriate at higher levels. The designers of the VFM Focus tool do not advocate strict adherence to the lower level outputs without a qualitative assessment made by experienced practitioners in the area of acquisition. It would be naive to expect that an assessment tool can give you accurate outputs without any management or technical oversight.

Table 2.3**Base ship selection evaluation criteria and Project Office assessments**

Criteria	Weighting	2 nd Ranked Ship ^(a)		DELOS	
	(%)	(Score out of 10) ^(b)	(weighted assessment)	(Score out of 10) ^(b)	(weighted assessment)
Performance	50	7	3.5	7	3.5
Program	30	0	0.0	0	0.0
Commercial	20	5	1.0	5	1.0
<i>Subtotal</i>			4.5		4.5
Overall Merit Rating^(c)			5		6
Indicative Price ^(c)			US\$ 33m+		US\$ 36 m
Value for Money Rating^(b)			0.15		0.17

Notes: (a) The 2nd Ranked Ship and the DELOS were rated by the DMO Project Office as essentially equivalent in all material aspects except for age and price, with the 2nd Ranked Ship being approximately two years older than the DELOS.

(b) Per assessment reports provided by the DMO Project Office to ANAO on 14 July 2006.

(c) Evaluation results recorded in the Base Ship Selection Evaluation Report of 18 May 2004. The Value for Money Rating was calculated by the DMO Project Office by dividing the Overall Merit Rating by the Indicative Price for each ship.

Sources: DMO Proposal Evaluation Plan, Base Ship Selection Evaluation Report and individual ship evaluation data reports.

2.33 DMO assessed that both ships were essentially equivalent on all selection criteria, except those criteria relating to the ability of DMO to pay for the vessel prior to 30 June 2004. DMO reported that although the 2nd Ranked Ship met or exceeded the Base Ship Specification requirements and would be relatively easy to modify, it was concerned that the vessel was under charter and that this issue could affect the short term spend profile requirement of spending the money in the financial year. DMO advice to the then Minister for Defence in late April 2004, and again in mid May 2004, was that: one of the key objectives associated with the base ship purchase is completion of the purchase in the financial year.

2.34 Defence advised the ANAO in December 2006 that:

The Project acted under Ministerial direction to maintain a mandated schedule and indeed the history of the Project has shown that if the ship had not been purchased at that time, the in-service date of September 2006 would not have been achieved. The key factor in favour of DELOS was that it was new, with a full warranty period that could be novated to the Commonwealth, and that

design data was available. Having the design data available from the manufacturing ship yard was critical to the successful on time and on budget achievements of the Project.

2.35 DMO advised the ANAO that there were no criteria in any of the Project's plan and evaluation documents to spend funds by 30 June 2004. The DMO Project Office's Proposal Evaluation Plan, released in April 2004, identified criteria and overall evaluation weightings for availability (18 per cent) and spend profile (9 per cent). Against these criteria, the DMO Project Office's May 2004 Base Ship Evaluation Report assessed the 2nd Ranked Ship's value as 'marginal' and 'poor to marginal' respectively, which were lower ratings than for the DELOS. The Report stated that the 2nd Ranked Ship was under charter and that this may restrict delivery with a consequent impact on the short term spend profile requirement of spending the money in the financial year. The Report's comments on the DELOS, against the availability criteria, stated that the ship is available for sale prior to 30 June 2004.

2.36 The Base Ship Evaluation Selection Report ranked the DELOS as the preferred ship. DMO advised the then Minister for Defence on 18 May 2004 that it intended to enter into negotiations for the purchase of the DELOS and, subject to the associated due diligence inspection and provision of mandatory documentation, that it expected that settlement would occur in June 2004.

Purchase Contract

2.37 DMO finalised a Memorandum of Agreement for the purchase of the DELOS with Panama based Mediterranean Fame S.A., as the Seller, in late May 2004. Mediterranean Fame S.A., a subsidiary company of Tsakos Energy Navigation, was the owner of the DELOS in accordance with the Construction Contract for the DELOS. The Memorandum of Agreement provided for the delivery of the DELOS to the Commonwealth at the agreed price of \$US35.7 million on the intended delivery date of 18 June 2004.

2.38 Under the Construction Contract for the DELOS, the Shipbuilder provided to the Buyer (Mediterranean Fame S.A.), for a period of 12 months from the date of delivery of the DELOS, guarantees for the vessel and all its parts, machinery and equipment.⁵⁶

⁵⁶ This guarantee was provided for defects which are directly due to defective designs, materials, construction miscalculation and/or poor workmanship; provided such defects have not been caused by the perils of the sea, rivers or navigations, or by normal wear and tear, overloading, improper loading or stowage, normal corrosion of the unprotected material, fire accident, incompetence, mismanagement, negligence or wilful neglect or by alteration or addition by the Buyer not previously approved by the Shipbuilder.

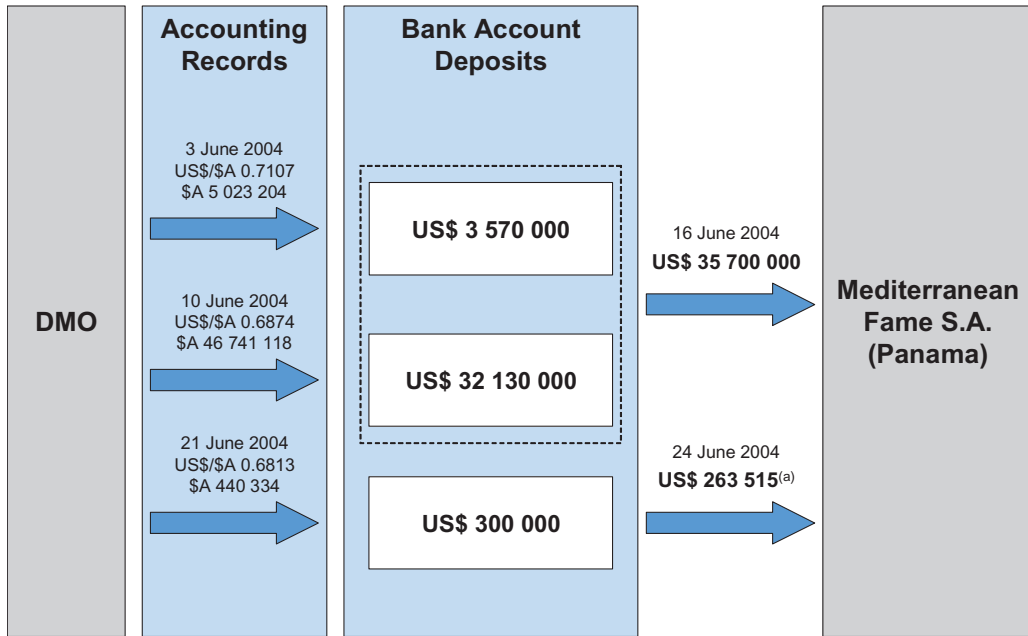
2.39 DMO, as part of its contract negotiations to purchase the DELOS from the Seller, successfully novated the Construction Contract's warranty obligations to the Seller to the Australian Government.⁵⁷ In the 12 months of vessel operation following delivery, DMO made 104 warranty claims, 99 of which were honoured by the Shipbuilder.

2.40 The ship purchase was effected on 16 June 2004 with the payment of US\$35.963 million, which included an additional amount of US\$0.253 million for consumable items such as lubricant and fuel that were not provided for under the Construction Contract.

2.41 Tsakos Energy Navigation announced in early June 2004 that it had sold its product carrier DELOS to the Australian Navy for an estimated profit of \$US9 million. DMO advised that the US\$9 million profit was reflective of the overall market condition and that their consultant had advised that the price of 45 000 deadweight tonnage vessels had risen from US\$26 million to US\$39 million during the relevant period. Tsakos Energy Navigation's profit was realised on the Construction Contract executed with Hyundai Mipo Dockyard in late 2002 for one vessel, with options available for the purchase of a further five vessels of similar size. Tsakos Energy Navigation later reported that it had also sold the DELOS sister ship Dionisos in October 2005 for a profit of US\$18 million.

2.42 Figure 2.2 illustrates the timing and payment processes associated with the purchase of the DELOS.

⁵⁷ Under the Memorandum of Agreement, the Seller was to assist the Australian Government to arrange the transfer of all guarantees/warranties for the DELOS and its equipment from the Shipbuilder and its subcontractors. The Seller also undertook to remain at the Australian Government's disposal to assist with claims if any under the said warranties, but strictly on a best efforts basis and always without obligation.

Figure 2.2**Payments process for the DELOS purchase**

Note: (a) Following the deduction of its own fees of GBP £12,334.32, the London law firm returned a balance of US\$14 629 to the DMO on 14 July 2004.

Source: ANAO analysis of DMO records.

Foreign currency payments for the DELOS purchase

2.43 The purchase of the DELOS in June 2004 was required to be recorded in Defence's accrual Resources and Output Management and Accounting Network (ROMAN) system, documenting the capital expenditure of DMO. The Defence and DMO payments process, through the ROMAN system, actually reports the foreign exchange amount based on an indicative rate from the day immediately prior to the date that the payment instruction is entered into ROMAN.⁵⁸ The ANAO understands that this payments process is applied to all foreign exchange payments⁵⁹ made by all DMO projects. Defence advised the ANAO in December 2006 that more simply and accurately this issue is a systemic one relating to the processing of foreign currency transactions in ROMAN.

⁵⁸ In the nine months to 31 March 2006, DMO's total foreign currency payments totalled \$2.01 billion.

⁵⁹ See also the ANAO's 2006-07 Performance Audit of the Management of the Acquisition of the Australian Light Armoured Vehicle Capability (Audit Report No. 9, paras 4.17 to 4.23).

2.44 Recording the transaction amount on the actual date of each foreign exchange payment results in a \$1.1 million decrease in the Project's reported actual cash expenditure for the DELOS purchase, which is illustrated in Table 2.4.

Table 2.4

Comparison of recorded and actual Project cash expenditure for the DELOS purchase

Date	US\$ Expenditure	Reported Project Expenditure	Actual Project Expenditure	Difference
	(US\$ million)	(\$ million)	(\$ million)	(\$ million)
3 June 2004	3.57	5.02	5.00	(0.02)
10 June 2004	32.13	46.74	45.66	(1.08)
21 June 2004	0.30	0.44	0.44	(0.00)
Total	36.00	52.20	51.10	(1.10)

Note: Expenditure is rounded to the nearest \$0.01 million.

Source: ANAO analysis of DMO and RBA records.

3. DMO Chartering of the DELOS

This chapter examines the arrangements established by DMO for the commercial chartering of the DELOS.

Background

3.1 DMO advised the ANAO that once it had been established that the DELOS was to be delivered to the Commonwealth with adequate design data, one of the principal purposes of chartering was to provide the Navy with sufficient operational experience on the DELOS to inform the design process. DMO considered that the subsequent out-charter provided the Navy/Project the opportunity to gain operational experience that proved invaluable in the subsequent design phase and saved the Project significant monies in what was already a very tight budget.

3.2 To facilitate the commercial charter of the DELOS, the DMO entered two contracts with related companies of Teekay Shipping. DMO entered into a Ship Management Agreement (known as the 'Shipman Contract') with Teekay Marine in early June 2004. Through the Shipman Contract, the DMO outsourced the commissioning and operation of the DELOS, which included crew, technical and commercial management, to Teekay Marine.

3.3 The Shipman Contract permitted Teekay Marine to debit the Commonwealth's account to cover all expenses including Teekay Marine's management fee. The management fee was \$300 000 per annum, payable in monthly instalments in advance. Based on the initial Shipman Contract termination date of 31 December 2004, the initial commitment for the services to be provided was \$175 000 at \$25 000 per month.

3.4 DMO entered the second contract, the Navion Timecharter Agreement (known as the 'Navion Contract'), with Teekay Chartering in early July 2004.⁶⁰ Under the Navion Contract, DMO was to receive US\$15 000 per day to place the DELOS at Teekay Chartering's disposal. The hire charges earned under the Navion Contract were payable to Teekay Shipping, as the agent of the Commonwealth, monthly in advance.⁶¹ All Owner [Commonwealth] expenses under this Contract, except for the provision of fuel and certain other charter

⁶⁰ Teekay Shipping was nominated as the Australian Government's agent for the Navion Contract.

⁶¹ Clause 9(a) of the Navion Contract required that these funds were to be paid into an account in the name of Teekay Shipping.

related costs, were to be paid by DMO. These expenses were estimated by DMO to be US\$14 000 per day and were to be offset by the charter revenue received.

3.5 Separate contract approval documentation was not completed by the DMO for the Shipman and Navion Contracts, as it was DMO's intention that the delegate approval for the commissioning, management and commercial chartering of the DELOS would also cover the Shipman and Navion Contracts. However, the delegate approval of \$2.0 million did not correctly identify the parties contracted under the Shipman and Navion Contracts, nor did it cover the actual costs and revenues to the DMO of these contracts of some \$7.9 million and \$8.2 million (as estimated).⁶² Nevertheless, the Commonwealth was contractually bound by both of these contracts. Teekay Marine advised the ANAO in December 2006 that at the end of the Shipman Contract, all the chartering income had been used for vessel operating expenses; at the time of writing the Commonwealth owes money to Teekay Marine. The timeline of key events relevant to the commercial chartering of the DELOS is illustrated in Table 3.1 for the period June 2004 to June 2006.

Table 3.1

Key events relating to the commercial chartering of the DELOS: June 2004 – June 2006

Date	Event
June 2004	Purchase of the DELOS. DMO enters Shipman Contract with Teekay Marine.
July 2004	DMO enters Navion Contract with Teekay Chartering for the commercial charter of DELOS at US\$15 000 per day for a six month period.
December 2004	Navion Contract renewed for one month. Renewed for a further month in January 2005.
February 2005	Navion Contract renewed for a further six months at a rate of US\$15 500 per day.
August 2005	Navion Contract expires and the DELOS returned to Fremantle.
May 2006	DMO Financial Investigation Service commences audit of commercial chartering accounts.
June 2006	Official bank account established. Payment of remaining charter proceeds of \$0.68 million to the DMO Collector of Public Monies.

Source: ANAO analysis of DMO records.

⁶² The DMO advised the ANAO in late August 2006 that: at the end of the day that [\$2.0 million] was the maximum that we thought the Commonwealth exposure would be for, because we knew that there would be income derived from the charter process, and monies going out to pay for crew and expenses.

Banking arrangements

3.6 Funds from the commercial charter of the DELOS were payable to the Commonwealth for charter hire in the period from July 2004 to August 2005. Under Clause 7.1 of the Shipman Contract, all funds collected by Teekay Marine under the terms of the Contract, and any interest thereon, were to be held to the credit of the Commonwealth in a separate bank account. Clause 7.2 of the Shipman Contract provided that all expenses incurred by Teekay Marine under the terms of the Contract on behalf of the Commonwealth may be debited against the account referred to in Clause 7.1.

3.7 The ANAO observed that the hire charges of US\$15 000 a day received under the Navion Contract by Teekay Shipping, as the agent of the Commonwealth, were public monies within the definition of public money in Section 5⁶³ of the *FMA Act*. That is, the hire charges were monies in the custody or under the control of Teekay Shipping acting for or on behalf of the Commonwealth. Furthermore, the monies would also form part of the Consolidated Revenue Fund, having been earned and received by an agent of the Commonwealth.

3.8 DMO advised it had considered the *FMA Act* requirements and had concluded that the monies did not become public monies until the management contract had been reconciled and monies were due and payable to the Commonwealth. The DMO further advised the ANAO that: *the financial arrangements that were set up with Teekay were created in the context of attempting to operate effectively in an unfamiliar commercial environment within the bounds established by the Commonwealth Procurement Framework.*

3.9 In response to ANAO audit observations, DMO sought advice in April 2006 regarding the question of whether or not the revenues from the commercial charter were public monies and hence subject to the requirements of the Commonwealth Financial Framework. The legal and constitutional advice from the Australian Government Solicitor stated that:

⁶³ Public money means:

- a) money in the custody or under the control of the Commonwealth; or
- b) money in the custody or under the control of any person acting for or on behalf of the Commonwealth in respect of the custody or control of money;

including such money that is held on trust for, or otherwise for the benefit of, a person other than the Commonwealth.

... it is clear that the Ship Management Agreement requires at least a proportion of the receipts to be held 'to the credit of' the Commonwealth in a separate bank account. It also contemplates that amounts may be debited by the Manager against amounts standing to the credit of the account.

The amounts standing to the credit of the account would be 'public money'. Further, the debiting of those amounts would involve the expenditure of 'public money'.

The fact that no amounts appear to have been placed in a separate account for the benefit of the Australian Government may be relevant to whether there has been strict compliance with the terms of the Ship Management Agreement. However, it is not relevant to whether the money should be characterised as 'public money'.

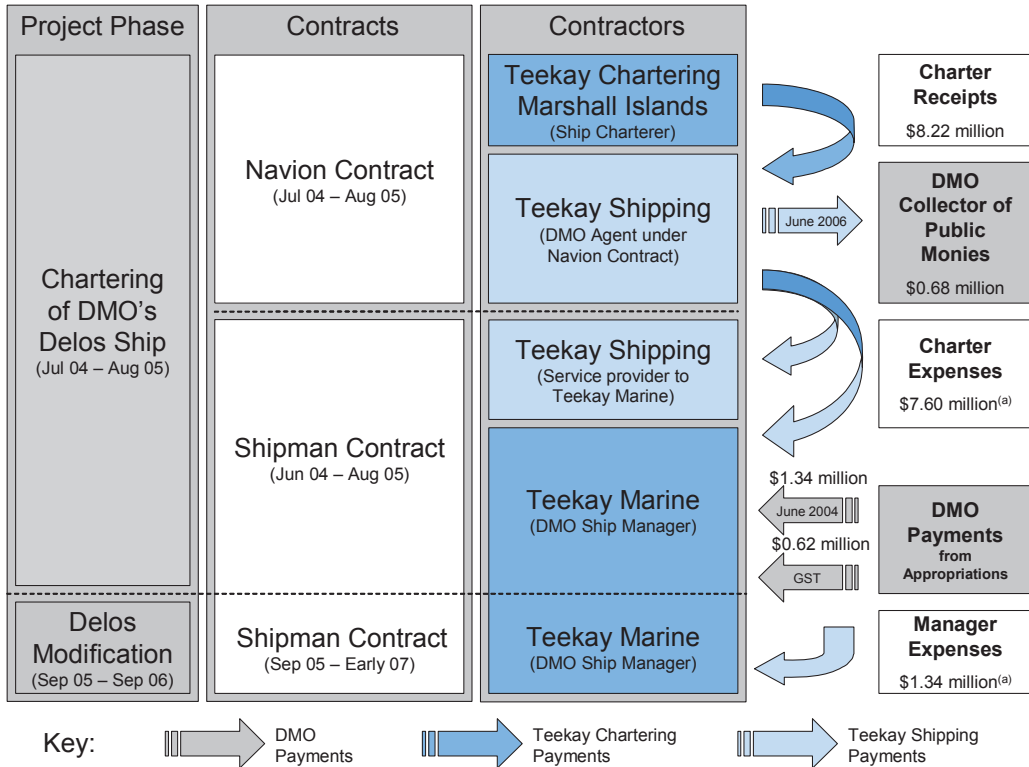
In our view, the arrangements under which Teekay Australia receives and deals with charter receipts does involve the receipt, custody and expenditure of 'public money' for the purposes of the *FMA Act*.

3.10 In light of this, the DMO applied to the Reserve Bank of Australia in June 2006 to create a new bank account to accommodate the receipt of money from Teekay Marine and payments by Teekay Marine to its subcontractors in accordance with the Shipman Contract.⁶⁴ DMO further requested that Teekay Marine be provided with a chequebook, in the name of the account, to facilitate subcontractor payments.⁶⁵ In late June 2006, Teekay paid \$683 547 to the DMO Collector of Public Monies. DMO reported that it had subsequently deposited \$546 723 into the new Official bank account, and \$136 794 in interest earned on the public funds during the charter period was credited to the Official public account.

3.11 Figure 3.1 summarises the cash flows arising from the commercial charter between: Teekay Chartering; Teekay Shipping as agent of the Commonwealth and custodian of the public funds; Teekay Marine as the ship manager; and DMO.

⁶⁴ The title of the new account was *Defence Materiel Organisation Official Departmental Account Teekay Marine Services bank account*.

⁶⁵ DMO requested that five Teekay Marine officials be provided with drawing rights to the bank account.

Figure 3.1**DMO internally audited DELOS charter and vessel management payments and receipts: as at 31 May 2006**

Note: (a) DMO's Financial Investigation Service funds management audit of the Navion Contract and Shipman Contract reported that, to 31 May 2006, the cost of the DELOS commissioning and chartering was \$7.60 million, while the cost of the DELOS management during modification was \$1.34 million. Both reported amounts are likely to be before GST. The Financial Investigation Service separately reported GST payments to suppliers of \$0.71 million, which is different to the value of DMO's GST contributions of \$0.62 million. DMO advised the ANAO in late August 2006 that it was satisfied that the residual amount of \$683 547, paid to DMO in June 2006, was correct.

Source: ANAO analysis of Defence and DMO records.

Contract management

3.12 Following the commencement of the Shipman Contract, Teekay Marine issued an invoice, identified as a 'cash call', to DMO on 16 June 2004 for \$1.336 million.⁶⁶ DMO approved the invoice for payment the next day, with payment received by Teekay Marine on 21 June 2004. A DMO report in

⁶⁶ The Defence Tax Management Office concluded in July 2006 that the transaction involved the transfer of funds to facilitate future disbursements under the Shipman Contract and that it appeared that there had not been a taxable supply at the time of payment.

June 2006 concluded that, against the \$1.336 million advance payment, the actual costs incurred were \$0.714 million.⁶⁷

3.13 The Shipman Contract required that Teekay Marine quantify its working capital requirement on a monthly basis, which was then to be funded by DMO on a monthly basis. DMO's June 2004 payment of \$1.336 million was the only working capital payment made to Teekay Marine during the chartering contract period.⁶⁸ The Shipman Contract, against which the advance payment was paid, did not explicitly identify that DMO would make a \$1.336 million 'cash call' to Teekay Marine.⁶⁹

3.14 Teekay Shipping advised the ANAO in December 2006 that:

We believe Teekay has complied with Clause 9.4 of the Shipman Contract, 'the managers [Teekay Marine] shall produce a comparison between budgeted and actual income and expenditure of the vessel in such form as required by the Owners [Commonwealth] monthly, or at such other intervals as mutually agreed'... the dates can be mutually agreed, which was the case here between DMO and Teekay Marine. All information was provided to DMO on the three prior and the subsequent audits that followed, as requested by DMO and at any other interval that ad-hoc reports or monthly reports were provided.

3.15 Further invoices were received from Teekay Marine between June 2005 and January 2006, totalling \$0.623 million, to reimburse the GST paid by Teekay Marine on taxable services provided during the charter period. DMO advised the ANAO in August 2006 that Defence had made reimbursements between 9 September 2005 and 20 January 2006 based on those invoices.

⁶⁷ DMO advised the ANAO in June 2006 that the services provided against this payment were provided in the period between 8 June 2004 and 24 June 2004. DMO made the payment without seeking any financial security. Defence advised the ANAO in December 2006 that a business decision was made at the time that concluded that the risk to the Commonwealth did not justify the need for an additional financial security.

⁶⁸ The ANAO's 2003-04 performance audit of Defence's Project Bushranger: Acquisition of Infantry Mobility Vehicles noted that:

Payments should not be made in advance of need for those purposes. This would prevent the contractor from using the funds for unrelated purposes, or distributing the payment as a dividend to shareholders.

⁶⁹ Teekay Shipping advised the ANAO in December 2006 that:

According to Clause 9 of the Shipman Contract, Teekay prepared and presented to the Commonwealth Teekay's estimate of the working capital requirement of the vessel as per Sub-Clause 9.3 (Shipman). It was agreed by the DMO following this cash call (advance payment) that these funds would be used to manage the vessel. In addition, the Shipman Contract states that managers shall in no circumstances be required to use or commit their own funds to finance the provision of the Management Services [Clause 9.5]. The concept of advance payments is common in the industry.

3.16 The normal approach to the payment of public money involves a Commonwealth agency receiving a payment invoice for services rendered and recording the transaction as soon as practicable on their Financial Management Information System. The invoice is then verified, which entails confirming that the amounts detailed on the invoice are correct and that the goods and/or services specified on the invoice have been satisfactorily received or performed. The invoice is also checked for tax validity prior to payment. Teekay Marine advised the ANAO that the standard industry practice is that a cash call, or budget, is submitted to the owner, the owner agrees with the amount and places funds with the manager in order to pay for the costs as they occur. This was done in the case of the DELOS, where a budget calculation on the operating costs was submitted to the DMO and approved in advance.

3.17 Teekay Shipping further advised the ANAO in December 2006 that:

There was no formal requirement for Teekay Marine to render monthly invoices (even though Teekay did prepare these on a monthly basis and made them available if so requested)... due to the mutually agreed process agreed to by the DMO for conducting audits and health checks during the course of the Project... At various points full sets of operating expenditure reports were provided to the DMO when requested. Teekay made the DMO aware that information would be available for inspection and auditing, subject to agreed times.

3.18 Defence and DMO did not apply the above procedures to payments for the 'other chartering and management expenses' made under the Shipman Contract. Accordingly, Defence and DMO did not exercise direct control over the 'other chartering and management related' public money expenditures.

Time charter rates

3.19 The Navion Contract, which commenced in July 2004 for a period of six months, was initially extended on a monthly basis. DMO decided to re-enter into another six month commercial charter period in February 2005. Under this extension, DMO negotiated an increase in the daily rate from US\$15 000 to US\$15 500. DMO advised the ANAO that the rates that were achievable for the original charter and re-charter were limited by the constraints that DMO imposed on its charter operation which included: restrictions on cargo type; operation only in the western pacific; sea-riding by Defence staff; in port access for DMO staff and contractors; a charter period limited to six months; an option to terminate the charter at any time; and a requirement to return the vessel to a location of the DMO's sole discretion.

3.20 DMO took advice in early February 2005 from Teekay Marine who proposed that the freight market was going to soften in 2005.

Financial reconciliation

3.21 The commercial charter finished in August 2005. The DMO advised the ANAO that validation of the total chartering revenue was intended to be undertaken only on completion of the Shipman Contract, which is now likely to be completed in early 2007. The ANAO notes that the DMO approval documentation of June 2004, for the commissioning, management and commercial chartering of the DELOS, identified that: *at the end of the charter period accounts will be available for audit and any surplus or shortfall would be to the Commonwealth's account.*

3.22 The DMO advised the ANAO that the agreement between DMO and Teekay was quite clear that reconciliation of funds would be undertaken on completion of the Shipman Contract. The Shipman Contract required that: *Teekay Marine at all times maintain and keep true and correct accounts and shall make the same available for inspection and auditing in relation to this Agreement by the Commonwealth at such times as may be mutually agreed.*

3.23 The total costs associated with the commercial charter, as recorded on the Teekay Marine monthly statements to September 2005, was \$7.99 million. Total charter revenues, as reported on the Teekay Marine monthly statements to September 2005, was \$8.22 million.

3.24 DMO initiated what it termed '*health checks*' of commercial charter expenses and receipts. No report was finalised for the initial '*health check*' conducted in November 2004. The second '*health check*' was conducted in October 2005 with a report finalised in February 2006. This report stated that the actual cash available to the Commonwealth as at 31 August 2005 was \$1.67 million. The DMO '*health check*' team assessed that there had been no misstatement of the expenses in the DELOS' operating account and that overall the account presented fairly.

3.25 In response to issues raised by the ANAO in March 2006, the DMO instructed its Financial Investigation Service in mid May 2006 to conduct an audit of commercial charter revenues and expenses received and paid by Teekay Shipping and Teekay Marine under the Navion Contract and Shipman Contract. The objectives of the DMO Financial Investigation Service audit included an examination of contractual compliance and to verify the funds

correctly due and payable to the Commonwealth that would be transferred from the Teekay account to a newly established Commonwealth bank account.

3.26 The DMO Financial Investigation Service conducted a funds management audit between late May 2006 and early June 2006, examining the accounts and records of Teekay Marine and Teekay Shipping in respect of the revenues and expenses arising from the management and commercial chartering of the DELOS. The Financial Investigation Service reported that it observed no discrepancies in respect of charter revenue receipts and no evidence of significant errors in the reporting of operating expenses.⁷⁰ The DMO Financial Investigation Service's major audit findings reported in June 2006 are outlined in Table 3.2.

⁷⁰ The Port Charges charged to the DELOS chartering account were revised in May 2006 resulting in a credit of \$69 297 in favour of the Australian Government.

Table 3.2

DMO Financial Investigation Service audit finding: June 2006

Area	Finding
Charter revenues (\$8.217 million)	Charter revenues totalling US\$6.236 million (A\$8.217 million) were received and this amount was reconciled to Teekay Marine's general ledger account without discrepancy.
Interest earned (\$136 794)	Total interest earned to 31 May 2006 was calculated to be \$136 794 based on applicable interest rates of 4.45 per cent and 4.60 per cent applied to the monthly balance of funds owing to the Commonwealth.
Advance payment (\$1.336 million)	Of the \$1.336 million paid to Teekay on 21 June 2004 for the DELOS commissioning expenses, only \$717 964 was reportedly used for this purpose. The Financial Investigation Service reported that, according to Teekay, at the end of September 2004 a meeting was held at Teekay's premises with the DMO Project Office's representative where it was agreed that the remaining monies from the commissioning funds, \$621 465, were to be kept for future activities other than costs associated with chartering. ⁷¹
Port charges ^(a) (\$69 297)	The Port Charges charged to the DELOS chartering account were revised in May 2006 resulting in a credit of \$69 297 in favour of the Commonwealth.
Account balance (\$683 549)	The balance of funds owing to the Commonwealth as at 31 May 2006 was agreed by DMO and Teekay Marine to be \$683 549, which included interest earnings of \$136 794.
Administration Fee (\$101 700)	DMO would examine the contractual legitimacy or otherwise of a flat three per cent administration fee, which was in addition to the monthly management fee, that was reportedly applied by Teekay Marine to crew wages and on costs with \$101 700 charged to the DELOS charter account.

Note: (a) Teekay Shipping advised the ANAO in December 2006 that: *Teekay had highlighted this prior to the audit commencing and had already adjusted the relevant months' accounts and also informed the DMO audit team in the introductions prior to the audit [Financial Investigation Service] commencing.*

Source: DMO Financial Investigation Service reports, 9 June 2006 and 26 June 2006.

Commonwealth Financial Framework

3.27 Charter revenues were received by Teekay Shipping as agent of the Commonwealth under the Navion Contract from July 2004 to September 2005. From these receipts, funds were withdrawn to acquit the operational and management expenses of Teekay Marine and its service providers for the

⁷¹ The DMO advised the ANAO in August 2006 that: *no formal agreement or otherwise allowed Teekay to retain funds for expenses unrelated to the charter. In this case \$717 964 was used for the establishment of the charter arrangements and the amount of \$621 465 was used to fund ongoing expenses arising from the charter, in accordance with agreed Project planning.*

DELOS from July 2004 to late May 2006. Public monies from the commercial charter were not paid to DMO until late June 2006.⁷²

3.28 DMO documentation for the management and chartering of the vessel stated that:

Funds to the credit of the management account will be used by Teekay Shipping for the running of the ship and maintenance requirements requested by Future Amphibious Sustainment Tanker System Program Office. At the end of the charter period accounts will be available for audit and any surplus or shortfall will be to the Commonwealth's account.

3.29 In response to the ANAO request for separate contract approval documentation for both the Shipman Contract and the Navion Contract, the ANAO was advised by DMO as follows:

Did we task a higher delegate submission to cover the total cost of Teekay managing the ship? No, because that would be offset by the charter monies earned, the money (other than the \$2 million) was not coming from a Government Appropriation and would never appear on ROMAN being the Department's official record of commitments entered into.

3.30 Section 81 of the Constitution states that: *all revenues or moneys raised or received by the Executive Government of the Commonwealth shall form one Consolidated Revenue Fund, to be appropriated for the purposes of the Commonwealth in the manner and subject to the charges and liabilities imposed by this Constitution.* In recent years, the Department of Finance and Administration (Finance) has undertaken significant work to develop a sound basis for understanding the composition of the Consolidated Revenue Fund. In this context, Finance has reached a number of conclusions about the nature and composition of the Consolidated Revenue Fund. These include the following.⁷³

- The Consolidated Revenue Fund is 'self-executing'. That is, all revenues or money received by the Commonwealth automatically form part of the Consolidated Revenue Fund, whether or not the Commonwealth has credited those monies to a fund or account which is designated as part of the Consolidated Revenue Fund.

⁷² The ANAO observed that the commercial charter revenues were not recorded against Defence's *FMA Act* Section 31 Agreement net appropriation and commercial charter revenues and expenses were not recorded in Defence's Financial Statements for 2004–05. In the event DMO had, in accordance with its stated intention of reconciling the Shipman Contract revenues and expenses only upon completion of the Contract, which has been extended to March 2007.

⁷³ ANAO submission of August 2006 to the Senate Finance and Public Administration References Committee for the *Inquiry into the Transparency and Accountability of Commonwealth Public Funding and Expenditure*.

- The Consolidated Revenue Fund includes money borrowed by the Commonwealth and ‘trust money’, as well as money in the nature of revenue. As a result, an appropriation is required to spend all such money, including that held on trust.
- The wide range of circumstances in which Commonwealth money is raised or received makes it impracticable to identify the precise balance of the Consolidated Revenue Fund at any particular time.

3.31 Accordingly, the charter revenues, as received public funds, automatically formed part of the Consolidated Revenue Fund when paid by Teekay Chartering into Teekay Shipping’s bank account. Section 83 of the Constitution requires that: *no money shall be drawn from the Treasury of the Commonwealth except under appropriation made by law*. In respect of the standard of records and controls required for appropriations, Table 3.3 outlines a Commonwealth agency’s responsibility for appropriation management.

Table 3.3

Agency responsibility for appropriation management

With the devolution of greater authority to agencies and the repeal of the *Audit Act 1901*, and the commencement on 1 January 1998 of the *Financial Management and Accountability Act 1997* and related Acts, there were important changes in appropriation management roles and responsibilities.

In particular, agencies have the following responsibilities:⁷⁴

- maintaining records of all appropriations, including any adjustments that occur over the course of the financial year;
- maintaining records that link, or are able to link, transactions to appropriations;
- recording amounts debited from appropriations prior to or as payments are made;
- ensuring that appropriations are not exceeded and are expended for the purpose appropriated; and
- implementing adequate controls over appropriations.

Source: ANAO submission to the Senate Finance and Public Administration References Committee for the *Inquiry into the Transparency and Accountability of Commonwealth Public Funding and Expenditure*, August 2006.

3.32 In light of issues raised by the ANAO⁷⁵ as to the Constitutional requirement for an appropriation under Section 83 to support the expenditure of public money, the DMO obtained legal advice from the Australian

⁷⁴ Finance Circular 2004/16, *Appropriation Management: Responsibilities of Agencies*, 28 October 2004, para 6.

⁷⁵ The Australian Government Solicitor provided separate legal advices to DMO in April, August and September 2006 on matters associated with: public money; the application of elements of the Financial Framework in the management of public money; and the Constitutional requirements for the expenditure of public money.

Government Solicitor in September 2006.⁷⁶ This advice to DMO clarified the Constitutional basis of the withdrawal of funds from the Consolidated Revenue Fund by Teekay Marine, which was:

... if there is an appropriation available to support expenditure, there is no breach of Section 83 of the Constitution in relation to the making of that expenditure ... Section 83, in its terms, does not require expenditure to be drawn down or recorded against a particular appropriation, or for a particular official to authorise expenditure.

Management of public funds

3.33 The *FMA Act* provides for the proper use and management of public money, public property and other Commonwealth resources. Part 3 of the *FMA Act* sets out mandatory requirements concerning the collection, custody and banking of public money. Part 4 sets out the mandatory requirements for accounting, appropriations and payments, including drawing rights. Part 7 sets out the special responsibilities of Chief Executives, including the recovery of debts.

3.34 Guidance from Finance⁷⁷ in July 2004 identified that: *drawing rights provided additional controls around the expenditure of money and the use of appropriations. Importantly, they allow control over who may lawfully draw upon appropriations and make payments, and allow for conditions and limits to be set in relations to those activities.*

3.35 As at 31 March 2006, the ANAO had identified that no money had been paid into a Commonwealth bank account, maintained by either Defence or DMO, as a result of the agreed charter of the DELOS which ended in August 2005 (see Figure 3.1). During audit fieldwork, the DMO advised the ANAO that it was an honest mistake that its staff and advisors believed that chartering receipts and expenses did not become ‘public monies’ until credited to a Consolidated Revenue Fund, which it planned to do at the completion of the chartering arrangements. The ANAO notes that the DMO did not require the public funds to be credited to a Commonwealth bank account upon completion of the chartering arrangements, which concluded in August 2005.

⁷⁶ Under the Legal Services Direction 2005, legal work is tied to the Australian Government Solicitor and the Attorney-General's Department if it involves constitutional law issues.

⁷⁷ Finance Circular No. 2004/07, 2 July 2004, *Drawing Rights: Payments and Debiting Appropriations*, p. 1, Key Points, para 1.

3.36 The level and standards of documentation considered necessary to support the payment of public money is a matter of judgement for management as part of the overall Defence financial control environment. The existence of appropriate documentation to support payments is important for Defence to enable it to:

- meet its *FMA Act* and FMA Orders obligations to maintain proper accounts and records;
- provide assurance to Ministers and Parliament that the departmental administrative procedures are adequate, reliable and authentic;
- provide assurance to management that the payment administrative processes have the necessary integrity to support the drawdown of Parliamentary appropriations; and
- provide support for the Commonwealth's position in the event of legal proceedings.

3.37 Non-conformities with the Commonwealth Financial Framework⁷⁸ that occurred during the chartering of the DELOS are listed in Table 3.4. This table also identifies the elements of the Commonwealth Financial Framework that were effectively rendered inoperable by the financial arrangements of Defence and DMO. These elements are designed to ensure that appropriate arrangements are made for the management of public money. The Australian Government Solicitor advised the DMO in early August 2006 that:

... the important point is that once the money is incorrectly characterised, a range of consequences will *necessarily* follow from that single misconception given that the *FMA Act* imposes various requirements in relation to the receipt, custody and expenditure of public money.

⁷⁸ The Australian Government Financial Framework is derived from the *Constitution* and includes the *FMA Act*, the FMA Regulations, FMA Orders, and agency Chief Executive Instructions.

Table 3.4**Defence and DMO adherence with the Commonwealth Financial Framework as at 31 March 2006**

Element	Description	Non-conformity	Inoperable
<i>Financial Management and Accountability Act 1997</i>			
Section 9(3)	Official bank accounts	Yes	
Section 10	Prompt banking of public money		Yes
Section 11	Public money not to be paid into a non-official account		Yes
Section 12	Finance Minister's authority needed for arrangements for the receipt or custody of public money by an outsider	Yes	
Section 13	Money not to be drawn from an official account without authority		Yes
Section 26	Drawing rights required for payment of public money	Yes	
Section 27	Finance Minister to issue drawing rights	Yes	
Section 47	Recovery of debts	Yes	
<i>Financial Management and Accountability Orders</i>			
Order 3.1	Prompt banking of received money		Yes

Source: ANAO analysis of Defence and DMO records and Australian Government Solicitor advices.

3.38 The Australian Government Solicitor advised the DMO in early August 2006 on the concept of public money under the Commonwealth Financial Framework (see Table 3.5).

Table 3.5

Australian Government Solicitor legal advice on public money

Before addressing the specific matters raised by the ANAO, it is appropriate to make a general observation about the present matter. Nearly all the instances of non-compliance with, or 'circumvention' of, the financial framework cited by the ANAO flow from a single misunderstanding on the part of Defence and DMO as to the strict legal position in relation the concept of 'public money'.

What might be thought on a quick read of the ANAO paper to be a litany of errors indicating chronic maladministration is, in fact, almost entirely explicable on the basis that the relevant officials when entering into the arrangements with Teekay Australia genuinely, but mistakenly, thought that the relevant receipts would not become 'public money' until they were actually received by the Commonwealth.

It is, in our experience, a common and honest misconception among Commonwealth officials that persons who are engaged by the Commonwealth to receive funds, such as organisers for events to be presented by the Commonwealth, may, consistently with the financial framework established by the *FMA Act*, retain their costs and fees from those receipts, forwarding only the balance of the funds to the Commonwealth Agency. This misconception seems to be based on the view that the Commonwealth's financial framework operates on a system of fund accounting under which amounts must be credited to a Consolidated Revenue Fund before they become 'public money'.

Be that as it may, the important point is that once the money is incorrectly characterised, a range of consequences will necessarily follow from that single misconception given that the *FMA Act* imposes various requirements in relation to the receipt, custody and expenditure of 'public money'.

Source: Australian Government Solicitor legal advice 2 August 2006.

3.39 The financial reconciliation of the DELOS commercial charter accounts of Teekay Shipping and Teekay Marine was completed in early June 2006. The balance of funds of \$0.68 million was paid to the DMO Collector of Public Monies on 29 June 2006.⁷⁹

3.40 The ANAO's audit has identified issues relating to adherence with key elements of the Commonwealth Financial Framework. This highlights that the risk of contravention of the Financial Framework can increase with transactions that are unusual, complex and/or infrequent. In such circumstances, a higher level of analysis or review often assists in mitigating risks.

3.41 DMO advised the ANAO that many of the claimed contraventions were unavoidable consequences of a single misunderstanding, which DMO considered ultimately caused no damage to the Commonwealth.

⁷⁹ Teekay Marine advised ANAO in December 2006 that at the end of the Shipman Contract, all the chartering income had been used for vessel operating expenses; at the time of writing the Commonwealth owes money to Teekay Marine.

Goods and Services Tax

3.42 The majority of invoices tendered by Teekay Shipping, for the purposes of GST payment by DMO, were dated 30 June 2005. Defence Tax Management Office's report in July 2006⁸⁰ stated that, according to the Defence accounting records system (ROMAN), Defence had paid a total of \$623 552 to Teekay Marine in respect of GST incurred in chartering expenses and other fees under the management agreement.

3.43 The ANAO notes that, in respect of the DMO Project Office's advance payment of \$1.336 million to Teekay Marine in June 2004, the invoice submitted did not comply with the legislative requirements for a tax invoice in that it did not include a description of each thing supplied (or to be supplied)⁸¹ and did not show the amount of GST payable. Defence advised ANAO in December 2006 that there was no underlying taxable supply, this invoice was correctly rendered; legislatively it could not be a tax invoice.

3.44 Teekay Shipping advised the ANAO in December 2006 that:

Teekay Marine had in fact supplied via an email on 2nd June 2004 to the DMO, a breakdown of the estimated amount to be used prior to the invoice or cash call been raised. In relation to the GST payable, according to GSTR 2000/35 Advance Payments paragraph 97, 'the component of the supply or acquisition to which the advance payment applies may not be readily identifiable, in which case, it will correspond to the proportion of the total payment represented by the advance payment [Subsections 156-5(2) and 156-10(2) of the GST Act]. In addition Teekay Marine were also awaiting feedback from DTMO via [DMO] on the GST status.

3.45 Teekay Marine consulted with DMO in 2004 on the correct form of tax invoice to be forwarded to the DMO. The DMO informed Teekay Marine that

⁸⁰ The Defence Tax Management Office analysis and advice to DMO in July 2006 was:

Defence Tax Management Office agree that the GST only invoices that Teekay Marine Pty Ltd provided for the payment by Defence do not meet the requirements for valid tax invoices as required by the GST legislation. The invoices do not provide adequate descriptions for acquisitions that the contractor has made on behalf of Defence. The supporting schedules attached to the invoices do not provide details on which of the acquisitions attracted GST and how much.

Defence advised ANAO in December 2006 that: *however, these were not the tax invoices that Defence relied to support its input tax credit claims.*

⁸¹ A valid tax invoice must correctly disclose the following in accordance with the Regulations:

- a brief description of each thing supplied; and
- a statement to the effect that the total amount payable includes GST for the supply or supplies; or
- the total amount of GST payable.

they were able to use the pro-forma invoice previously submitted as the tax invoice to be forwarded to the DMO. Teekay Shipping advised the ANAO in December 2006 that:

Teekay, acting as agents of DMO were informed that we were able to use these pro-forma invoices as the GST invoices to be forwarded to the DMO. In addition, DMO's email included an excerpt of the findings of the DTMO in relation to the contractual arrangement between the DMO and Teekay Marine and the GST impact. There were 2 major findings in that firstly there was a recommendation that DTMO should request a valid tax invoice from Teekay Australia before it will be entitled to claim an input tax credit (DMO had not requested this until recent post-audit) and that DMO and Teekay enter into a Sub-Division 153-B Agency Agreement whereby both parties will eventually be easier to manage. Teekay had requested to take this stance on Agency with DMO quite a few months ago with no response to date.

3.46 Defence advised ANAO in December 2006 that Teekay Marine and DMO are continuing their normal dialogue which is an important compliance task to ensure ongoing taxation management.

3.47 The DMO advised the ANAO in June 2006 that the \$1.336 million payment was made prior to an appropriate methodology being agreed between DMO, the Defence Tax Management Office and Teekay Shipping for the claiming and payment of GST. In relation to the methodology adopted by the DMO and Teekay Shipping, the ANAO observed that the revenue reported by Teekay Marine on the tax invoices tendered to DMO was consistently understated with respect to the actual charter earned and reported on Teekay Marine's monthly accounting statements for the DELOS. The reported objective of the arrangement was to report zero net revenue for the vessel charter.⁸²

3.48 Teekay Marine was considered to be Defence's agent and therefore, it was not necessary for the GST invoices issued by Teekay Marine to be valid tax

⁸² The Defence Tax Management Office analysis and advice to DMO in July 2006 was:

In addition each invoice also records the amount of charter revenue which is netted off against the expenses. For the purposes of the GST legislation the chartering revenue or chartering supplies made by Teekay Marine Pty Ltd on behalf of Defence should have been recorded separately, and the amounts should also have been included in the Defence business activity statements.

invoices to support Defence's claim for GST input tax credits.⁸³ In December 2006, Defence advised ANAO that Defence Tax Management Office has recently reconfirmed the Agent and Principal relationship requirements with the Australian Taxation Office.

Recommendation No.1

3.49 The ANAO recommends that where DMO:

- (a) seeks to enter commercial transactions that are unusual or complex, it conduct a higher level of analysis and / or obtain appropriate counsel to ensure these transactions specifically comply with the Commonwealth Financial Framework and the Goods and Services Tax legislative requirements; and
- (b) enters contractual arrangements which provide for public monies to be held in a separate bank account, that account should be established as an Official Account in accordance with the requirements of Section 9 of the *Financial Management and Accountability Act 1997*.

Defence and DMO response

- 3.50** (a) Agreed. This was applied in the case of the Fleet Oiler; and
(b) Agreed.

⁸³ The Defence Tax Management Office analysis and advice to DMO in July 2006 was:

However, considering that the arrangement between Teekay Marine Pty Ltd and Defence was that of an agent and principal, Teekay Marine Pty Ltd as the agent may make acquisitions on behalf of Defence, the principal. The agent can also hold the relevant valid tax invoices on behalf of the principal, whilst the principal is entitled to claim GST input tax credits in accordance with section 153-15 of *A New Tax System (Goods and Service Tax) Act 1999* (the GST Act). As Teekay Marine Pty Ltd as Defence's agent retained the valid tax invoices on behalf of Defence it was not necessary for the GST only invoices issued by Teekay Marine Pty Ltd to be valid tax invoices to support of Defence's claim for GST input tax credits.

4. Modification of the DELOS

This chapter examines the modification of the DELOS and the arrangements for the New Fleet Oiler's acceptance and introduction into Navy service.

Background

Navy Technical Regulation

4.1 Navy states that it is a mandatory requirement of the Navy Technical Regulatory System (NTRS) that organisations undertaking design, construction and maintenance of Australian Defence Force maritime materiel are to be authorised to undertake these engineering activities by the Navy's Technical Regulatory Authority, the Chief Naval Engineer.⁸⁴

4.2 Navy further identifies that the granting of Authorised Engineering Organisation (AEO) status is based on an appraisal of the current capability of the candidate for AEO to comply with the NTRS. The Chief Naval Engineer may grant full AEO status if the candidate achieves an appropriate level of adherence with the NTRS, or provisional status to those organisations that develop an acceptable Risk Treatment Program to address shortfalls.

4.3 The Amphibious Deployment and Sustainment (ADAS) program, within the DMO, is the organisation responsible for the oversight of the DMO Project. The DMO Project Office had fully achieved the target capability profile in every process area at the time of AEO assessment of the overall ADAS program, conducted between October 2005 and December 2005.⁸⁵ The ADAS program was awarded provisional AEO status by the Chief Naval Engineer and Director of Technical Regulation – Navy on 18 August 2006.

Modification strategy

4.4 The project management and modification of the DELOS is principally defined and governed by the Shipman Contract and the Ship Refit and Repair

⁸⁴ Navy states that Authorised Engineering Organisation (AEO) status is the basis of the assurance of technical integrity of Australian Defence Force maritime materiel provided by the Chief Naval Engineer to the Chief of Navy.

⁸⁵ The DMO Project was also led by an authorised Level 2 Engineering Authority.

Contract.⁸⁶ The timeline of key events relevant to the modification of the DELOS is illustrated in Table 4.1.

Table 4.1

Key events relating to the modification of the DELOS

Date	Event
October 2004	Request for Tender released for the modification of the DELOS.
March 2005	Contract for the modification of the DELOS entered with Tenix Defence Pty Ltd with a value of \$63.1 million.
August 2005	Navion Contract expires and DELOS returned to Fremantle.
September 2005	Modification Contract production work commences.
August 2006	Delivery and DMO acceptance of Tenix modification work. Test and evaluation of suitability of delivered modification work.
September 2006	Commissioning of the modified vessel as SIRIUS.
October 2006	Chief of Navy grants Initial Operational Release following acceptance of ship safety documentation.
February 2007	Expected finalisation of the consolidation of Approved Base Ship, Tenix and Rexroth Safety Case Reports into the Automated Maintenance Planning System (AMPS).
Mid 2007	Expected Operational Release of SIRIUS.

Source: ANAO analysis of DMO records.

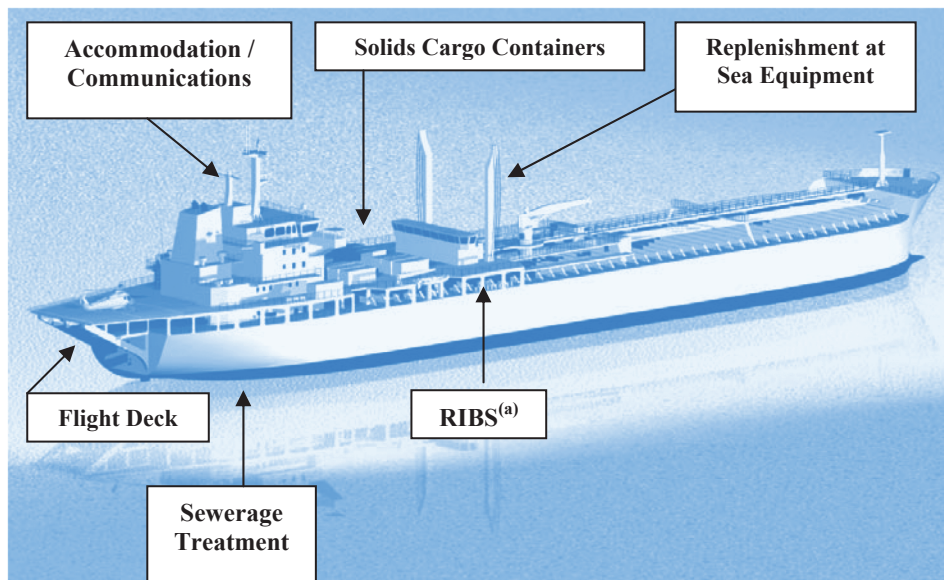
4.5 DMO originally intended to implement a staged vessel modification contracting strategy, with separate contracts to be let for the modification design and build activities. In July 2004, DMO advised the then Minister for Defence that it would combine the design and build contracts into a single tender. DMO identified that the combined design and modification strategy would produce a six month schedule saving, providing for the delivery of the modified vessel to Navy in mid 2006.

4.6 In support of this decision, DMO in July 2004 noted that it had secured sufficient documentation from the Shipbuilder to enable detailed design to proceed with a minimum of ship checking. DMO stated that the physical baseline of the chosen vessel had a significant inherent capability and therefore, the modification activities would be limited to three main areas: replenishment at sea rig modification; habitability modifications; and basic RAN communications. These features are illustrated in Figure 4.1.

⁸⁶ The Ship Refit and Repair Contract provided for the modification of the DELOS by Tenix Defence Pty Ltd to provide Navy with a vessel capable of conducting underway replenishment of fuel (diesel and aviation) and water.

Figure 4.1

Modification works to be completed by the DMO Project



Notes: (a) Rigid Hull Inflatable Boats (RHIBs) were transferred from WESTRALIA.

Source: ANAO analysis of DMO records.

Tender evaluation

4.7 The tender was issued on 23 August 2004, with responses due by 21 October 2004. The Tender Evaluation Plan for the DMO Project stated that tenderers were required to quote on the basis of:

- (a) a fixed price for the conduct of the design and ship modification tasks that will enable the modified vessel to meet all the 'essential' requirements specified in the Function and Performance Specification and an 'important' helicopter capability; and
- (b) prices for additional work to meet specified Function and Performance Specification requirements not provided for under (a).

4.8 Proposals were to be assessed against evaluation criteria. The evaluation criteria sought to establish a common assessment baseline against which all proposals were to be compared and formed the basis for making informed value for money judgements. The overall assessment was to involve

a comparison of the financial assessments against the value ratings to ensure a value for money outcome. Proposals were to be set aside when they did not meet one or more essential criterion.

4.9 The tender was restricted to the four pre-qualified Ship Repair and Refit Panel Agreement panellists. Of the four panellists, only two responded in their own right, as prime contractors, to the DMO Project's tender request. DMO reported that neither of the two tender responses were set aside during the screening process.

Comparative tender value

4.10 The DMO Project Office conducted its tender evaluation across three key performance areas: technical capability; project management; and commercial aspects. Separate working groups were established to conduct comparative evaluations in each of these areas, as detailed below:

- **Technical evaluation:** The DMO Project Office stated that the technical evaluation of the tender was primarily focused in establishing the level of compliance with five distinct elements. The DMO Project Office concluded that the successful tenderer's proposed design for the replenishment at sea capability represented an excellent solution for Navy.⁸⁷
- **Project management and commercial evaluation:** The DMO Project Office assessed that, on balance, the successful tenderer's submission was superior in the project management and commercial terms that it proposed. Upon completion of the tender evaluation and finalisation of the Source Evaluation Report, in respect of the commercial terms proposed, the DMO Project Office noted that, for both tenders, it had residual concerns in the contractual areas of: limitation of liability; liquidated damages; financial securities; warranty and latent defects; insurance; and intellectual property.

Comparative tender cost

4.11 The DMO Project Office reported that the unsuccessful tenderer initially tendered a price for the vessel modifications of \$60.41 million

⁸⁷ The DMO Project Office's tender evaluation was facilitated by the use of proprietary software into which compliance or capability assessments were input for each work element, along with an assessment of the attendant risks. The results were aggregated up to an overall assessment for each compliance area or capability.

(excluding GST). The DMO Project Office did not consider this price to be appropriate for the purposes of comparative evaluation as it did not include, inter alia, the cost of replacing the communications equipment, which was initially to have been recovered from WESTRALIA, nor did it include the cost to fully conform with Safety of Life at Sea standards.

4.12 The DMO Project Office estimated that the cost of the additional items not included in the scope of work quoted by the unsuccessful tender would be \$6.48 million.⁸⁸ The DMO Project Office assessed that the significantly higher price for the replenishment at sea equipment, together with the exclusion of the communication equipment cost from the tendered price, meant that the unsuccessful tenderer's proposal was high risk in financial terms. The DMO Project Office used a total tender price of \$66.89 million for the purposes of comparative evaluation.

4.13 The DMO Project Office reported that the successful tenderer initially tendered a price for vessel modifications of \$50.47 million (excluding GST). This price also had to be adjusted for the replacement of the communications equipment that could no longer be sourced from WESTRALIA and for the cost of full Safety of Life at Sea conformity; as well as for additional costs for the replenishment at sea equipment integration. The DMO Project Office estimated the total cost of these items to be \$11.56 million, resulting in an effective tender price of \$62.03 million for the purposes of comparative evaluation.⁸⁹

4.14 The Source Evaluation Report stated that both tenderer's proposed fixed price contracts were not subject to price variation. The DMO Project Office assessed that the projected contract price of the successful tenderer represented a low risk to the DMO as the cost of the replacement communications equipment was included in its adjusted price. DMO reported that the successful tenderer's offer was considered advantageous as it did not require an advance or mobilisation payment at the time of the tender submission.

⁸⁸ This amount did not include the replacement cost for the communications equipment, which was estimated by the DMO Project Office to cost a further \$5 million to \$6 million.

⁸⁹ The DMO Project Office stated that should this tender be successful, a number of additional items needed to be added to the scope of work quoted. On this basis, the DMO Project Office noted that the projected contract price would be \$65 614 590. The ANAO was unable to reproduce this estimate from Project Office data records.

Vessel Modification Contract

4.15 The Commonwealth signed a fixed price, milestone based contract with Tenix Defence Pty Ltd (hereafter known as the 'Prime Contractor') on 15 March 2005 to modify the DELOS in order to provide Navy with a vessel capable of conducting underway replenishment of fuel (diesel and aviation) and water. The Contract value at contract signature was \$63.055 million.

4.16 The initial Contract value was to be paid in 14 milestone payments⁹⁰ over 18 months, ending with the delivery and acceptance of the modified vessel on 15 September 2006. The Contract price included two mobilisation payments totalling \$4.55 million, which were due and payable to the Prime Contractor upon contract signature.⁹¹ In respect of the successful tenderer's offer, DMO advised the ANAO that:

The offer did not include advance payments. However, subsequent to approval of the Source Evaluation Report, the System Requirements Review upgraded a number of capability packages, specifically for Communications and the Sewage Treatment Plant. As a consequence, the successful tenderer was required to identify and order long lead material for those packages. The upgrades also required a corresponding increase in design effort from both successful tenderer and its equipment suppliers. This compelled the successful tenderer to 'front load' the design process with additional resources.

4.17 The Modification Contract included an incentive payment regime to provide an additional incentive for the Prime Contractor to deliver the modified vessel back to DMO on or before the scheduled completion date. The maximum incentive payment of \$1 million was to be paid to the Prime Contractor if the modified vessel was accepted by the DMO on or before 31 July 2006. The incentive payment reduced by \$0.25 million for every week after 31 July 2006 that the modified vessel did not receive acceptance by DMO. Vessel acceptance after 21 August 2006 would not attract any incentive payment.

4.18 In the event that the amended contract milestones numbers five (Critical Design Review) and sixteen (Acceptance) were not achieved on schedule, liquidated damages were to apply as the rates of \$7 000 and \$35 000 per day respectively. The amount of liquidated damages payable under the

⁹⁰ As at early April 2006, the Contract had been amended to comprise of 16 milestone payments (including final acceptance).

⁹¹ Under the Modification Contract, the Prime Contractor was to provide DMO with a \$2.28 million mobilisation security against this payment. The mobilisation security provided by the Prime Contractor was an increased amount of \$3.27 million.

Modification Contract was capped at \$5 million. At the maximum rate of \$35 000 per day, this amount equates to a maximum liability period of approximately 142 days. Early delivery of the vessel reduced the amount of any accrued liquidated damages from late achievement of the Critical Design Review milestone by \$7 000 per day for each day that Acceptance milestone is achieved ahead of the milestone date.⁹²

4.19 Further protection against contractor underperformance was to be provided by two financial securities for performance, each valued at a fixed five per cent of the Modification Contract price at contract signature (\$3.15 million). This arrangement meant that these securities would not automatically increase in line with any contract growth.

4.20 The Modification Contract provided for the release of the first performance security upon achievement of the Acceptance milestone, with the second released after Final Acceptance.⁹³

4.21 The Contract acceptance process permits the Prime Contractor to deliver the modified ship, along with all necessary supporting documentation, to DMO once it considers that its contractual obligations have been fulfilled. Following delivery, DMO was obligated to accept or reject the contracted work, subject to minor omissions or defects, within a period of 21 days. In the case that the work is fully accepted by DMO, the delivery date is the date used to determine whether or not an incentive payment or liquidated damages are payable.

Project Safety Case Report

4.22 The purpose of a Safety Case Report is to document how safety considerations have been incorporated into a ship and its integrated support system design.⁹⁴ The Safety Case Report is used to determine whether the certification requirements have been satisfied, and that system hazards have been identified and reduced to defined acceptable levels. The Safety Case Report is a mandatory requirement to demonstrate that the objectives of the

⁹² The DMO advised the ANAO in August 2006 that it had notified the Prime Contractor that it would reserve its rights in regards to recovery of liquidated damages, together with advice that liquidated damages accrual commenced, following the Prime Contractor's breach of the Critical Design Milestone, in September 2005.

⁹³ Final Acceptance under the Modification Contract is defined by Project Authority endorsement of the Final Acceptance Certificate to the effect that the Prime Contractor has achieved all previous milestones and Acceptance of all supplies.

⁹⁴ ANAO's 2004–05 Audit of the Armidale Class Patrol Boat Project, p. 63, para 4.42

Navy Safety Manual (NAVSAFE) have been met. The Safety Case Report is an important element of the performance and safety baseline against which Contract deliverables should be tested and evaluated as being fit for purpose.

4.23 The draft Formal Safety Assessment document for the DMO Project identified that the DMO Project's Safety Case Report would consist of five parts: Part 1: Introduction; Part 2: Capability Description; Part 3: Formal Safety Assessment; Part 4: Safety Management System; and Part 5: Emergency / Contingency Plan. As of early September 2006, the Capability Description, Formal Safety Assessment and the Emergency / Contingency Plan components had not been completed. The Safety Management System had been completed and was awaiting approval.

4.24 The Modification Contract required that the Prime Contractor deliver the final Safety Case Report to DMO by 15 October 2005, 11 months prior to anticipated delivery of the modified ship. Access to the Safety Case Report was initially requested by the ANAO in January 2006, at which time the DMO Project Office advised that the Safety Case Report was still in draft, three months after it was to be delivered under the Modification Contract. The DMO Project Office's Safety Case Report Communication Plan, released in November 2005, had proposed that the Safety Case Report would be approved by the DMO Project Office in June 2006.

4.25 Immediately prior to the vessel delivery and DMO Acceptance date, the DMO Project Office advised the ANAO that the Safety Case Report had still not been finalised and could not be completed until the Configuration Baseline for the whole ship had been agreed between the DMO Project Office and the Prime Contractor. The DMO Project Office stated that it would not require the Prime Contractor to finalise the Safety Case Report until after the completion of the acceptance testing program. For this Project, the acceptance testing program was to be conducted after delivery and DMO Acceptance of the modified vessel, which occurred on 7 August 2006.⁹⁵

4.26 Defence advised the ANAO in December 2006 on the safety framework for SIRIUS that had been developed by the DMO Project in conjunction with Navy, and considered by Navy prior to granting Initial Operational Release (see Table 4.2).

⁹⁵ The DMO Project Office advised the ANAO in July 2006 that the Prime Contractor would be required to investigate any deficiencies that arise as part of the testing program to insure they do not individually or collectively impact on the final Safety Case Report.

Table 4.2

Defence advice on safety framework for SIRIUS

All the elements of the safety case were in place and were accepted by Chief of Navy when he granted Initial Operational Release, however there is still a requirement to develop the Whole Ship Safety Case (WSSC) in AMPS, which will pull together the individual safety case reports and High Risk Maintenance Items (HRMI) from Tenix, Rexroth and LR [Lloyds Register] Base Ship Certificates. As previously advised the WSSC must be loaded into the ship's maintenance management system, AMPS, and this cannot be completed until the final configuration baseline has been established in AMPS. This has recently been completed and work on the WSSC has commenced. It is important to understand the relationship of the LR Certificates to the Tenix and Rexroth Safety Case reports, specifically, each of the classification societies has its own set of Rules and Regulations, normally known as the Rules. The major classification societies are members of the International Association of Classification Societies (IACS) and, generally speaking, their Rules are very similar, which enables owners to transfer their vessels between classification societies. The Rules set standards for the design, construction and ongoing maintenance of ships. A society's classification services are designed to ensure that a vessel is maintained in accordance with these Rules.

When a vessel is built to Class Rules a certificate is issued on completion that states that the vessel was constructed to the Rules and meets the required standards of the Rules. The Rules are effectively the certification baseline. In effect, the certificate is the Objective Quality Evidence (OQE) that the Rules have been met. There are, in fact, several certificates. The major classification societies are authorised by flag administrations and national governments to verify that vessels registered under their flags comply with IMO codes such as MARPOL and Safety of Life at Sea. This collection of certificates provides the OQE that the vessel meets these requirements. It should be noted that DELOS was in Class with LR.

The Safety Case (SC) was developed for self-regulating industries, such as the offshore oil and gas industry, to demonstrate that they are capable of meeting the requirements for safe operation and environmental protection within their industry. The IMS Code is not a substitute for the SC, as the SC is a much more in-depth approach to safety analysis (for example the development of HRMI by Tenix, Rexroth and Teekay); it looks at the total integration of the entire system and all of the support facilities. This integration is described in the SIRIUS Safety Management System, developed by Navy and in the Safety Case Communication Plan. In the case of the Navy, as a government agency it is not obliged under international regulation to meet the requirements of the IMS Code. However, the Commonwealth has obligations and responsibilities under OH&S and environmental legislation and Navy has chosen to use the Safety Case, as embedded in the Naval Technical Regulatory Framework, as the means to ensure that these obligations and responsibilities are achieved. The task referred to here, and at Paragraph 20, is the integration of the Safety Case elements provided by Teekay, LR, Tenix and Rexroth into a single document that will form an essential part of AMPS. This work is on schedule for delivery in February 2007. The delay from the original contracted date reflects the decision by the in-service support agency, AASSPO, to maintain configuration control of SIRIUS in AMPS rather than in Teamcentre, which is a new configuration management tool currently being rolled out across the Navy.

Source: Defence advice to ANAO in December 2006.

4.27 It is clearly desirable, from a risk management perspective, that Safety Cases for major capital assets are finalised prior to the contractual acceptance of those assets by DMO so that system hazards have been adequately identified and the exposures managed to acceptable levels.

Contract amendments

4.28 The first Contract Change Proposal and Contract Amendment was agreed between the Prime Contractor and the DMO Project Office as part of the \$10 million compensation package negotiated in April 2005 between Tenix Defence Pty Ltd and the Commonwealth for an extended schedule delay on an unrelated DMO project. Under this agreement, the Modification Contract price was reduced by \$7.12 million. The DMO have reported that the balance of the compensation of \$2.88 million was to be applied to the installation of navigation systems on ANZAC ships.

4.29 As a consequence of these arrangements, the Modification Contract price was reduced from \$63.055 million to \$55.935 million. The price reduction was phased across a number of milestones. Following the Contract Amendment, the DMO Project's approved budget was reduced by \$2.985 million.

4.30 Following the reduction in the Contract price, DMO agreed to increase the total amount of the mobilisation payments available under the Contract from \$4.55 million to \$10.26 million.⁹⁶ The DMO advised the ANAO in June 2006 that the Prime Contractor had initially proposed to increase the total amount of mobilisation payments to \$16.75 million.⁹⁷

4.31 The financial securities against both mobilisation payment and contractual performance totalled \$9.58 million, which was less than the total mobilisation payment of \$10.26 million. DMO advised the ANAO that financial security against the mobilisation payment was returned to the Prime Contractor in mid October 2005.

Contract payments

4.32 The Modification Contract stated that the Prime Contractor may submit an invoice only in accordance with the payment schedule. The payment schedule at Contract signature specified the payment milestones and did not contemplate the submission of invoices as progress claims against Contract

⁹⁶ The ANAO notes that the total mobilisation payment increased by 124 per cent, whereas the mobilisation security only increased from \$2.28 million to \$3.27 million or 44 per cent.

⁹⁷ The DMO advised the ANAO that it had agreed to a redistribution of the milestone payments under the Contract in order to address cash flow issues being experienced by the Prime Contractor with regard to this Project. The new mobilisation milestone covered the ordering of long lead items, placement of certain subcontracts, and the mobilisation of the Prime Contractor's team on site in Western Australia. The DMO advised that the aim of increasing the total amount of mobilisation payments was to reduce risk in the Contract schedule.

milestones. The Contract contains a clause to permit part payment of a milestone payment claim where part of the work subject to claim was rejected by DMO. The DMO advised the ANAO in June 2006 that it considered that the existence of this clause meant that both parties contemplated part payments of milestones at the time of contract signature.

4.33 To the end of June 2006, the DMO Project Office had approved payments to the Prime Contractor totalling \$45.5 million, or nearly 75 per cent of the Contract value.⁹⁸ The payments for all elements of the design phase of the DMO Project were completed after the respective original milestone payment dates. Part or progress payments were also made for each of the design phase elements, with DMO withholding full payment until each of the elements were assessed as complete.⁹⁹ Final invoices for the design phase elements, supported by the Prime Contractor's design certificate for the platform system, were tendered for Project Office approval in early May 2006.

Design Certification and Acceptance

4.34 The Navy Technical Regulations Manual (NTRM) identifies that the purpose of the Project Certification Plan is to document how the System Program Office (SPO) or Project intends to certify acquired materiel. To provide confidence that the assurance provided by the System Program Office or Project Director is credible, there is a requirement for objective quality evidence that individual requirements have been assessed by competent authorised individuals, who are acting in the role of Design Acceptance Representatives. The NTRM states that design certification is to be undertaken by a Design Acceptance Representative that must not have been involved in the design.

4.35 The DMO Project's October 2004 Certification Plan identified the DMO Project Director as the Design Acceptance Representative for almost 80 per cent of the listed design elements. Defence advised the ANAO that the Design Acceptance Representative did not attend Detailed Design Review,

⁹⁸ As part of the audit process, the ANAO requested access to review the test reports associated with the production work completed by the Prime Contractor. The DMO Project Office stated that the idea of a test program is to demonstrate the progressive readiness of supplies. The Project Office advised the ANAO in July 2006 that although the Prime Contractor had undertaken numerous tests and inspections, which had been observed by Commonwealth personnel, it would not normally get a report until completion of the test program. The Project Office further advised the ANAO that, under the Modification Contract, the Prime Contractor was not required to provide test reports to the DMO until the date of Acceptance. Defence advised the ANAO in December 2006 that all Test Reports have been delivered by Tenix in accordance with the requirements of the Contract.

⁹⁹ The Project Office advised the ANAO in May 2006 that the Prime Contractor would not issue the final design certificate until the completion of appropriate testing.

Critical Design Review or the Test Readiness Review and thereby maintained the independence required under the Navy Technical Requirements Framework.

4.36 The DMO advised the ANAO in July 2006 that: all outstanding design issues raised by Defence and DMO had been closed out; DMO and Defence had approved the initial design through the Detailed Design Review and Critical Design Review processes and sign-offs; and final acceptance would be subject to the issue of a Class Certificate by the International Classification Society.¹⁰⁰

4.37 The ANAO requested access to the DMO Project Office's design issues management database. The ANAO was advised that the database was maintained by a contractor in the United Kingdom and that it was not readily available for ANAO review. At the end of audit fieldwork in late August 2006, the ANAO had not been able to verify that all outstanding design issues had been closed out, or that Defence and DMO had formally signed off on the design.

4.38 Defence advised the ANAO in December 2006 that:

The close out of all design issues has been demonstrated through the issue of certificates under the Project Certification Plan. These certificates have satisfied the requirements of the Chief Naval Engineer and Director General Navy Certification, Safety and Acceptance who have provided advice to Chief of Navy allowing the granting of Initial Operational Release. The Navy Operational Test and Evaluation framework seeks to capture any outstanding design issues in the TI338. The TI338 delivered by the Project and accepted by Navy contains no outstanding design issues.

Schedule performance

4.39 Notwithstanding the existence of part payments against a revised set of Contract milestones, Figure 4.2 shows that Project expenditure lagged the Contract milestone baseline as at 30 June 2006, which was one month before the originally scheduled early delivery of the modified vessel on 31 July 2006. The shaded area of Figure 4.2 illustrates under-expenditure against the contract milestone baseline since August 2005, when the DMO Project's design deliverables were scheduled for completion. DMO advised the ANAO in

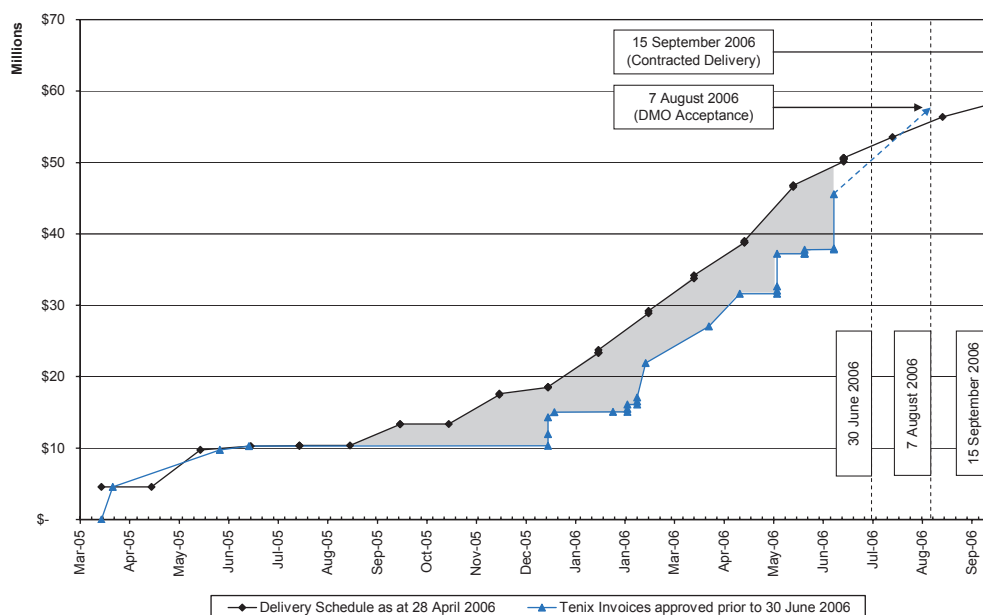
¹⁰⁰ During the modification phase, the International Classification Society was contracted to the Prime Contractor and not to the Australian Government.

June 2006 that it considered that it was appropriate to withhold payments until the work had been completed.

4.40 Despite the lag in Prime Contractor progress against the Contract milestone baseline to 30 June 2006, the DMO reported on 7 August 2006 that the Prime Contractor had, in just over a month, recovered the Contract slippage to deliver the modified vessel to DMO for acceptance, five weeks ahead of the Contract schedule. DMO advised the ANAO in late August 2006 that schedule recovery had been facilitated by the Prime Contractor's application of additional resources in the final stages of the DMO Project.

4.41 As at Contract signature, the Critical Design Review milestone date was 15 July 2005. The Critical Design Review milestone was not submitted for final DMO acceptance until 8 May 2006. Against the revised milestone date for the Critical Design Review of 15 September 2005, 235 days of liquidated damages at \$7 000 per day, or \$1.65 million in total, was available as a debt payable to the Commonwealth. Under the Contract, the early delivery of the modified vessel on 7 August 2006 reduces the amount of accrued liquidated damages by \$0.27 million to \$1.38 million. Defence advised the ANAO in December 2006 that the delay in achieving Critical Design Review was in fact due to a third party being unable to provide timely sign-off on the Structural Design Analysis due to competing priorities.

4.42 Under the Modification Contract, liquidated damages do not accrue or become payable until achievement of the contracted Acceptance milestone. DMO initially advised the ANAO that it would address the issue of liquidated damages at the time that the Acceptance Milestone was achieved, in accordance with the Contract. In December 2006, the DMO advised the ANAO that it is currently seeking legal advice from the Australian Government Solicitor regarding the applicability of liquidated damages in this situation.

Figure 4.2**Record of Modification Contract payments to 30 June 2006**

Note: As at 30 June 2006, the only milestone that remained part paid was the Test Readiness Review, with the payment balance against this milestone being \$0.22 million. The balance of the shaded area, as at 30 June 2006, related to contract milestones that were not complete at their respective milestone date.

Source: ANAO analysis of DMO records.

4.43 DMO advised the ANAO that, with the exception of some Contract Change Proposals and items of Government Furnished Equipment, the Prime Contractor had presented the modified vessel to DMO on 7 August 2006. The Modification Contract provided for DMO and Navy evaluation of the delivered supplies over a 21 day contractual acceptance period.¹⁰¹

Contractual Acceptance

4.44 On 7 August 2006, and in accordance with the acceptance process outlined in the Modification Contract, the Prime Contractor offered the contracted Supplies for Acceptance by DMO. On the same day, the DMO Project Authority signed off that the Supplies detailed in the Contract were Accepted without prejudice to the DMO's remedies under the Contract in the

¹⁰¹ Within thirty (30) days of achieving early delivery, the Project Authority shall assess the information provided under Clause 10.9 (incentive payment) and inform the Contractor of the amount of incentive payment awarded, if any.

event that the Supplies did not conform in all respects with the conditions and requirements of the Contract.

Report of the Materiel and Equipment Performance State

4.45 In accordance with the Contract, the Prime Contractor attached its Report of the Materiel and Equipment Performance State (the 'Report') to the Supplies Acceptance Certificate. This records and ascribes, at the time of delivery, responsibility for the rectification of any deficiencies that are unacceptable to the DMO.¹⁰²

4.46 The Report stated that it would initiate the development of the Initial Operational Capability Statement by the Navy Test Evaluation and Acceptance Authority (RANTEAA),¹⁰³ which in turn would facilitate the Initial Operational Release¹⁰⁴ by the Chief of Navy.¹⁰⁵ The Report identified that the final Operational Capability Statement is released at Operational Release (at the final acquisition milestone and at the end of Naval Operational Test and

¹⁰² In its audit of DMO's Management of the Tiger Armed Reconnaissance Helicopter Project – Air 87 (Audit Report No.36, 2005–06), the ANAO was advised that it is the DMO's practice to accept deliverables with contractual shortfalls, and operational limitations, on a risk managed basis.

¹⁰³ The Naval Operational Test and Evaluation Manual (*Australian Books of Reference* (ABR) 6205) states that the Royal Australian Navy Test Evaluation and Acceptance Authority (RANTEAA) is tasked, inter alia, with providing Navy Capability Managers with independent and objective advice as to the actual capability of new platforms and systems entering naval service.

The Naval Operational Test and Evaluation Manual (NOTEMAN) is identified in the RAN publication series as ABR 6205. ABR 6205 is authorised by the Chief of Navy and sponsored by the Commander Australian Naval Systems Command. The status of ABR 6205 in the general hierarchy of orders is clarified in DI(N) ADMIN 100-12 *Australian Books of Reference and their Application to the Command of the RAN*. While ABR 6205 does not possess the same legal authority as a Defence Instruction, the instructions are issued under the general power of command vested in Chief of Navy over the RAN.

¹⁰⁴ The Naval Operational Test and Evaluation Manual (ABR 6205) notes that:

The Initial Operational Release process must ensure that all safety aspects are addressed and that at the appropriate milestones it is demonstrably safe to proceed to the next stage of the process. The Materiel Certification Plan is a key document used to support this process. A documented Safety Case will be required for Initial Operational Release. The Safety Case is a tool used to establish and manage safety (ABR 6306 – NAVSAFE Manual – Navy Safety Management refers). Its objectives are to:

- a. provide a description of the capability;
- b. ensure an active safety management system;
- c. identify hazards;
- d. analyse their cause and potential harm, then proceed accordingly; and
- e. make certain that effective emergency plans and controls are current, and communicate the risk and what to do in a mishap (Incorporating March 2006 effected amendments, paragraph 5.11)

¹⁰⁵ Initial Operational Release is the milestone at which Chief of Navy or Deputy Chief of Navy, on the advice of Maritime Commander Australia and Commander Australian Naval Systems Command, is satisfied that the operational and materiel state of a new capability of equipment, is such that it is: fit for purpose; and safe to proceed to the post-Delivery phase of the acquisition program.

Evaluation period), at which time the capability is effective, reliable, safe to use and almost satisfies user expectations.

4.47 Part 1 of the Report comprised six sections including: Contractor Responsible Deficiencies; Contract Amendment Related Work; Integrated Logistics Support Deficiencies; Outstanding Test and Trials; Software Related Problems; and issues that Defence and the DMO deemed to be of concern. The Report did not identify any Software Related Problems or any issues that Defence and the DMO deemed to be of concern.

4.48 In respect of Outstanding Tests and Trials, the Report listed in excess of 100 pre-delivery tests and trials that had not been satisfactorily conducted by the Prime Contractor at Acceptance. A sample of the outstanding tests with direct implications for safety is presented in Table 4.3.

4.49 Defence advised the ANAO in December 2006 that:

RANTEAA did raise a number of safety related concerns at delivery but these were unrelated to the Tenix scope of work and have since been rectified by other contractors. The source of this information "Report of the Material and Equipment Performance dated 7th August 2006" (the TI338) has a section specifically for recording any safety related issues and none of these issues has at any time appeared in this section. Had any safety deficiencies been identified they are required either to be remedied or mitigated prior to the granting of Initial Operational Release.

Table 4.3**Safety related tests and trials not completed at Contractual Acceptance:
7 August 2006**

Tests and Trials Not Completed	
Accommodation:	Domestic Fridge/Freezers Equipment; Sprinkler Piping Pressure Test; Galley Fire Extinguishing System Equipment; Sprinkler Operational Test; and Fresh Water Service System Chlorination Test
Aviation Deck:	Firemain Piping Pressure Test; and FPF (fire fighting foam) Piping Pressure Test
Sewerage:	Plant Equipment; Plant Piping Pressure Test; Plant Tank Pressure Test; Plant Collection System Test; Plant Biofilter Test; Plant Sludge Management System Test; System Operational Test; and System Environmental Certification
Platform:	Doors and Hatches; Breathing Air Compressor Operational Test; Navigation and Signal Lighting Functional Test; Switchboards and Transformers Operational Test; and Inclining Experiment
Replenishment at Sea:	Deck FPF (fire fighting foam) Test
Lifeboat:	Davit Set To Work and Load Test

Source: Report of the Materiel and Equipment Performance State (TI338 Form), 7 August 2006.

4.50 The DMO Project Office advised the ANAO that:

There are a number of compartments not accepted and some testing outstanding as of 7 August 2006. Tenix were requested to delay final testing and presentation of some compartments pending completion of the installation, set to work and testing of GFE [Government Furnished Equipment] (primarily C4 equipment) by Commonwealth Agencies. Once the Commonwealth Agencies have completed their work and are off the ship, Tenix will undertake a final 'paint touch up' and clean before presenting the

compartment. You will note also that the Project has documented individual deficiencies in the compartments not accepted.¹⁰⁶

Navy Test and Evaluation

4.51 The Naval Operational Test and Evaluation Manual (NOTEMAN) states that the naval test and evaluation period overlaps three milestones in the acquisition process.¹⁰⁷ At each milestone, certain requirements must be met prior to the Project progressing into the subsequent phase.

4.52 NOTEMAN acknowledges that the Navy has a fundamental need to be a credible, independent test and evaluation organisation. RANTEAA is tasked, inter alia, with providing Navy Capability Managers with independent and objective advice as to the actual capability of new platforms and systems entering naval service.

4.53 After DMO acceptance of the vessel, RANTEAA reported that it had led an Initial Operational Release inspection team for the modified vessel and provided suitability advice on: the material state of compartments and

¹⁰⁶ DMO further advised the ANAO that:

Final sign off of the machinery spaces will be delayed until testing of the sewerage treatment plant (need full crew). Tiller flat area delayed until completion of painting in the aft peak tank (tasked contracted by the Project to EPTEC). Completion of set to work and testing of RAS system delayed due to late delivery of Government Furnished Equipment/Information from Rexroth. Container deck delayed until completion of repairs and testing of boat cranes (Government Furnished Equipment). Some minor work still outstanding on late Contract Change Proposals - ships self defence, boat boom for lifeboat davit and satellite TV system. Some additional work required in the superstructure spaces to meet RAN revised requirements for physical security and Tempest. Final testing and compartment sign off will not be undertaken until production work for these additional requirements is complete. Integrated Logistics Support deliverables have been delivered in accordance with the contract and are currently under review by the SEA1654 Technical Support Network.

¹⁰⁷ These requirements are:

- Delivery – is the milestone at which the contractor demonstrates, to the satisfaction of the Project Manager, that the specifications and associated requirements of the contract have been met. Project Office staff measure contractor compliance with the contract using data from Design Test and Evaluation, Production Test and Evaluation and Validation and Verification activities.
- Initial Operational Release – where a capability system will be formally offered for Initial Operational Release assessment when the DMO is satisfied that the conditions for Initial Operational Release commencement have been met. This will normally occur at, or shortly after Delivery. 'Ownership' of the system passes from the DMO to the Chief of Navy represented by Maritime Commander Australia, at which point the Royal Australia Navy Test, Evaluation and Acceptance Authority and associated agencies conduct Form TI 338 (Report of the Materiel and Equipment Performance State) based inspections / audits to produce the Interim Operational Capability Statements.
- Operational Release – is the final milestone in the acquisition process. Operational Release is achieved when Chief of Navy (CN), on the recommendation of Commander Australian Naval Systems Command (as advised by Director RAN Test, Evaluation and Analysis Authority) and endorsement of Maritime Commander Australia, is satisfied that the equipment is in all respects suitable for operational service. CN must also be satisfied that sufficient information on the capability is held to allow for the safe and effective employment of the capability.

equipment; the extent of deficiencies observed and the recommended action, Occupational Health and Safety issues; and the suitability of the modified vessel to meet with RAN requirements.

4.54 The deficiency list reported by the Initial Operational Release team was intended to supplement any issues or deficiencies identified by the DMO Project, RAN regulators or their delegates and the Amphibious and Afloat Support Force Element Group. The RANTEAA report identified a number of safety related deficiencies at the time of inspection that included those listed in Table 4.4.

Table 4.4
Safety related deficiencies as identified by RANTEAA: August 2006

RANTEAA Reported Deficiencies	
No Compartment names and Damage Control markings ^(a)	
Domestic power outlets (GPOs) not marked with source breakers	
No Escape signs	
No RADHAZ (Radio Hazard) signs/markings ^(b)	
No Automatic battery emergency lighting ^(c)	
Test tallies for fuel, hydraulic and flexible hoses not sighted/missing	
No Clear operating instructions on all machinery	
Flex Hoses on Diesel not tagged	
Sprinkler activation for the Small Arms Magazine not certified	
No first aid equipment evident	

- Notes:
- (a) RANTEAA stated that these markings are required to assist crew and sea riders when locating compartments, dealing with incidents and rapid exit from the NUSHIP SIRIUS.
 - (b) RANTEAA reported that it was awaiting completed RADHAZ Survey by Tenix staff of the platform and seaboats. RANTEAA stated that Initial Operational Release will not be approved without a completed RADHAZ survey.
 - (c) RANTEAA stated that this is especially relevant in the Machinery Spaces near the Emergency Exits as a loss of main or back up lighting will mean escape areas are not visible and could become catastrophic.

Source: RANTEAA Initial Operational Release Team Inspection Report, 15 August 2006.

4.55 Defence advised the ANAO in December 2006 that:

Seven of the 10 items have now been rectified, 2 have been mitigated with rectification action due for completion by 12 November 2006 and one has been mitigated by Standing Operating Procedures while a configuration change is developed. All were outside the contractual obligations of the prime contractor. Tenix did however assist the Commonwealth in rectifying many of these deficiencies and in most cases did not seek a contract change or additional funding.

The DMO Project Office advised the ANAO that, from early September 2006, Teekay would take the ship to sea and assume full management responsibility, operating it within the Teekay Safety Management System. The DMO Project Office further advised that Teekay would work with the International Classification Society to re-issue amended class and statutory certificates/letters of compliance, and had arranged for an Australian Maritime Safety Authority surveyor to carry out an inspection to confirm ship's compliance with statutory regulations.



Ian McPhee
Auditor-General

Canberra ACT
30 January 2007

Appendix

Appendix 1: Defence and DMO Response

DEFENCE AND DMO COMBINED RESPONSE TO THE ANAO REPORT ON
THE PURCHASE, CHARTERING AND MODIFICATION OF THE NEW
FLEET OILER

REFERENCE	RECOMMENDATION	DEPARTMENT RESPONSE
Recommendation No. 1 Para 3.45	<p>The ANAO recommends that where DMO:</p> <ul style="list-style-type: none">a) seeks to enter commercial transactions that are unusual or complex, it conduct a higher level of analysis and/or obtain appropriate counsel to ensure these transactions specifically comply with the Commonwealth Financial Framework and the Goods and Services Tax legislative requirements; andb) enters contractual arrangements which provide for public monies to be held in a separate bank account, that account should be established as an Official Account in accordance with the requirements of Section 9 of the <i>Financial Management and Accountability Act 1997</i>.	<ul style="list-style-type: none">a. Agree. This was applied in the case of the New Fleet Oiler.b. Agree

Defence Comment:

Project SEA1654 Phase 2A (WESTRALIA Replacement) has provided Defence with an unprecedented opportunity to demonstrate the successful application of Kinnaird Review principles. The DMO has applied innovative techniques to

the solution of a complex problem and met, or exceeded, all capability, safety, budget and schedule requirements.

Innovation in this Project has included the use of commercial standards (classification society rules) where appropriate, commercial contracting templates and contracting incentive arrangements. This has resulted in achievement of the desired capability ahead of schedule and within budget.

The DMO's business-like approach to the use of different methods of contracting has been vindicated. The DMO continues to be innovative and look for the best contracting method based on the risk profile of each project. In this case, knowing that there would be obstacles if our identity as a government organisation was disclosed, we decided to purchase the vessel on the open market using a standardised commercial contract format that met all international standards. The DMO then continued to be innovative by leasing the vessel back to the market while it undertook the competitive tender process for the refit activity.

In this Project, the DMO was highly responsive to Government. The requirement under the original Defence Capability Plan was for a vessel to be delivered in 2009 and a project budget of about A\$450 million. That plan was substantially revised by Government following the Defence Capability Review (November 2003). Changes to international regulatory standards have led to an accelerated timetable for the withdrawal of single hull oil tankers like WESTRALIA. Although warships are not strictly bound by these regulations, the environmental impacts and the risk of limited future access to international waters were key factors in the Government decision to bring forward the replacement of WESTRALIA from 2009 to 2006.

The project has also been an excellent example of achieving results in partnership with industry. The contract for the refit and modification of the tanker was awarded to Tenix, with the majority of work completed in Western Australia. The contract included incentives for completing the work ahead of schedule. Over a period of 18 months, and with a number of difficult issues to resolve along the way, Tenix completed the work on budget and have received incentives for completing the work ahead of schedule.

Defence regrets that it might be inferred from this report that there are shortcomings in the safety program. Any such suggestions have now been proven baseless through a rigorous test and evaluation process. The delivery of safe capabilities and the safe operation of those capabilities in service is an absolutely key focus for Defence.

Index

B

Bank account, 16, 22, 24, 54-56, 61, 64-65, 67, 71, 95

C

Capability, 6-8, 11, 13-15, 20-22, 27-29, 34, 37-43, 46, 72, 74-75, 77, 79, 86, 89, 96,
Contractual acceptance, 5-6, 18, 80, 82, 85, 88

D

Defence Procurement Review, 14, 22, 38-40, 95

F

Financial Management and Accountability Act 1997 (FMA Act), 7, 11, 17, 19, 24, 55-56, 63-68, 71, 95, 101
Financial reconciliation, 6, 17, 44, 54, 57, 60-62, 68

G

Goods and Services Tax (GST), 5, 7, 18, 21, 24, 32, 57-71, 76, 95,

I

International Maritime Pollution Agreement (MARPOL), 8, 11, 14,

29-31, 36-38, 80

L

Legal advice, 6, 19, 43, 64, 68, 84

N

Navion Contract, 12, 15-16, 32, 53-55, 57, 59-60, 62-63, 73
Navy Technical Regulation, 8, 72, 82

P

Public money, 6, 16, 24, 55-56, 59, 63-68, 71, 95

R

Report of the Materiel and Equipment Performance State (TI 338), 83, 86-89

S

Safety Case, 6, 8, 19-20, 73, 78-80, 86
Shipman Contract, 15, 17, 53, 56

T

Tenix Modification Contract, 5-6, 12-13, 15, 18-21, 23, 41, 43, 57, 72-74, 77-85, 87-88, 90, 96
Two-pass approval, 5, 12, 14, 38-40

Series Titles

Audit Report No.1 Performance Audit
Administration of the Native Title Respondents Funding Scheme
Attorney-General's Department

Audit Report No.2 Performance Audit
Export Certification
Australian Quarantine and Inspection Service

Audit Report No.3 Performance Audit
Management of Army Minor Capital Equipment Procurement Projects
Department of Defence
Defence Materiel Organisation

Audit Report No.4 Performance Audit
Tax Agent and Business Portals
Australian Taxation Office

Audit Report No.5 Performance Audit
The Senate Order of the Departmental and Agency Contracts
(Calendar Year 2005 Compliance)

Audit Report No.6 Performance Audit
Recordkeeping including the Management of Electronic Records

Audit Report No.7 Performance Audit
Visa Management: Working Holiday Makers
Department of Immigration and Multicultural Affairs

Audit Report No.8 Performance Audit
Airservices Australia's Upper Airspace Management Contracts with the Solomon Islands Government.
Airservices Australia

Audit Report No.9 Performance Audit
Management of the Acquisition of the Australian Light Armoured Vehicle Capability
Department of Defence
Defence Materiel Organisation

Audit Report No.10 Performance Audit
Management of the Standard Defence Supply System Remediation Programme
Department of Defence
Defence Materiel Organisation

Audit Report No.11 Performance Audit
National Food Industry Strategy
Department of Agriculture, Fisheries and Forestry

Audit Report No.12 Performance Audit
Management of Family Tax Benefit Overpayments

Audit Report No.13 Performance Audit
Management of an IT Outsourcing Contract Follow-up Audit
Department of Veterans' Affairs

Audit Report No.14 Performance Audit
Regulation of Pesticides and Veterinary Medicines
Australian Pesticides and Veterinary Medicines Authority

Audit Report No.15 Financial Statement Audit
Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2006

Audit Report No.16 Performance Audit
Administration of Capital Gains Tax Compliance in the Individuals Market Segment
Australian Taxation Office

Audit Report No.17 Performance Audit
Treasury's Management of International Financial Commitments—Follow-up Audit
Department of the Treasury

Audit Report No.18 Performance Audit
ASIC's Processes for Receiving and Referring for Investigation Statutory Reports of Suspected Breaches of the Corporations Act 2001
Australian Securities and Investments Commission

Audit Report No.19 Performance Audit
Administration of State and Territory Compliance with the Australian Health Care Agreements
Department of Health and Ageing

Better Practice Guides

Implementation of Programme and Policy Initiatives:

Making implementation matter	Oct 2006
Legal Services Arrangements in Australian Government Agencies	Aug 2006
Preparation of Financial Statements by Public Sector Entities	Apr 2006
Administration of Fringe Benefits Tax	Feb 2006
User-Friendly Forms	
Key Principles and Practices to Effectively Design and Communicate Australian Government Forms	Jan 2006
Public Sector Audit Committees	Feb 2005
Fraud Control in Australian Government Agencies	Aug 2004
Security and Control Update for SAP R/3	June 2004
AMODEL Illustrative Financial Statements 2004	May 2004
Better Practice in Annual Performance Reporting	Apr 2004
Management of Scientific Research and Development Projects in Commonwealth Agencies	Dec 2003
Public Sector Governance	July 2003
Goods and Services Tax (GST) Administration	May 2003
Managing Parliamentary Workflow	Apr 2003
Building Capability—A framework for managing learning and development in the APS	Apr 2003
Internal Budgeting	Feb 2003
Administration of Grants	May 2002
Performance Information in Portfolio Budget Statements	May 2002
Life-Cycle Costing	Dec 2001
Some Better Practice Principles for Developing Policy Advice	Nov 2001
Rehabilitation: Managing Return to Work	June 2001
Internet Delivery Decisions	Apr 2001
Planning for the Workforce of the Future	Mar 2001
Contract Management	Feb 2001
Business Continuity Management	Jan 2000

Building a Better Financial Management Framework	Nov 1999
Building Better Financial Management Support	Nov 1999
Managing APS Staff Reductions (in Audit Report No.49 1998–99)	June 1999
Commonwealth Agency Energy Management	June 1999
Cash Management	Mar 1999
Security and Control for SAP R/3	Oct 1998
Selecting Suppliers: Managing the Risk	Oct 1998
New Directions in Internal Audit	July 1998
Controlling Performance and Outcomes	Dec 1997
Management of Accounts Receivable	Dec 1997
Protective Security Principles (in Audit Report No.21 1997–98)	Dec 1997
Public Sector Travel	Dec 1997
Audit Committees	July 1997
Management of Corporate Sponsorship	Apr 1997
Telephone Call Centres Handbook	Dec 1996
Paying Accounts	Nov 1996
Asset Management Handbook	June 1996

