

The Auditor-General
Audit Report No.45 2009–10
Performance Audit

Contracting for Defence Force Recruiting Services

Department of Defence

Australian National Audit Office

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Canberra ACT
17 June 2010

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Department of Defence in accordance with the authority contained in the *Auditor-General Act 1997*. I present the report of this audit and the accompanying brochure. The report is titled *Contracting for Defence Force Recruiting Services*.

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

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Abbreviations

ADF	Australian Defence Force
AGS	Australian Government Solicitor
ANAO	Australian National Audit Office
APS	Australian Public Service
CMG	Chandler Macleod Group
CPGs	Commonwealth Procurement Guidelines
CRMC	Candidate Relationship Management Centre
DFR	Defence Force Recruiting
DFRC	Defence Force Recruiting Centre
DGDFR	Director General Defence Force Recruiting
DPPM	Defence Procurement Policy Manual
DSC	Defence Service Centre
DSG	Defence Support Group
EATS	Employment advice and transition service
GFE	Government Furnished Equipment
IT	Information Technology
ITR	Invitation to Register Interest
JOS	Job Options Services
KPI	Key performance indicator
PSER	RFT Preliminary Source Evaluation Report
RFT	Request for Tender
SOW	Statement of Work
SRT	Specialist Recruitment Team

Summary and Recommendations

Summary

Introduction

1. Defence force recruitment is a major undertaking given the size of the Australian Defence Force (ADF) (some 55 081 permanent and 20 277 Reserve personnel as at 30 June 2009),¹ the diverse range of personnel required by the three Services—the Navy, the Army and the Air Force—and the fact that Defence must compete with Australian business and industry to attract the required recruits, both skilled and unskilled.

2. Defence Force Recruiting (DFR) Branch, the responsible area within Defence, delivers recruitment services to the ADF with the assistance of a recruiting services prime contractor, a range of subcontractors to the prime contractor and the Defence Support Group (DSG), which provides the Defence Service Centre (DSC) (a call centre in Cooma).² Recruitment directives (targets) are developed by Defence to meet future ADF capability requirements. DFR Branch aims to meet these targets under a single, major contract that provides for recruiting services to be delivered by 16 Defence Force Recruiting Centres (DFRCs) (jointly staffed by both personnel employed by the prime contractor and ADF personnel) and a dedicated Candidate Relationship Management Centre (staffed by the prime contractor's personnel),³ with the support of the DSC operated by DSG personnel.

3. As at 10 March 2010, Defence employed 232 full-time ADF personnel and 26 Defence Australian Public Service (APS) personnel to deliver Defence Force Recruiting (DFR); and Manpower Services (Australia) Pty Ltd (Manpower), the current prime contractor, employed an additional 330 permanent and 113 casual or contract personnel. The DSC employs around 72 full-time and nine part-time APS personnel to manage a range of call centre

¹ Department of Defence, *Annual Report 2008–09*, Defence, Canberra, 2009, Volume 1, pp. 27–28.

² With Defence's agreement, a Prime Contractor may engage a range of subcontractors in order to deliver the full range of services required by Defence (for example, marketing, medical and IT services). The Defence Service Centre in Cooma, New South Wales, provides a range of call centre functions for Defence, including for Defence Force Recruiting, and is the initial point of contact for over 40 per cent of all enquiries from people seeking information about careers in the ADF. The arrangement is underpinned by a Service Level Agreement between the two areas in Defence.

³ A dedicated Candidate Relationship Management Centre (CRMC) was established in Melbourne to actively support candidates through the ADF recruiting process and improve the recruitment process by enabling regular contact between potential candidates, ADF personnel and DFR staff.

activities for Defence, including initial call reception for Defence Force Recruiting. The number of stakeholders involved in delivering defence force recruitment services, and shared responsibilities, adds to its complexity from a management and resourcing perspective.

New recruiting service delivery model

4. During 2007–08, Defence began working with its then prime contractor for recruiting services, Manpower,⁴ on implementing a new recruiting service delivery model (the New DFR model). At the same time, the department was also undertaking an open tender process for a contractor to deliver recruiting services into the future under the New DFR Recruiting Services Contract (the New DFR Contract). The changes to the service delivery model were incorporated into the New DFR Contract and the model was fully implemented nationally by 20 November 2008.

5. On 2 July 2008, Defence signed a contract with the successful tenderer Chandler Macleod Group (CMG). From 1 February 2009, following a seven month transition period, CMG took over the provision of ADF recruiting services. The contract was for a five year term ending on 1 February 2014. In July 2008, the then Minister for Defence, Science and Personnel announced that the total estimated cost of this contract over its five year term would be up to \$405 million.⁵ However, Defence and CMG agreed in October 2009 after only 9 months of operation, subject to the satisfaction of certain conditions, to the early termination of the contract. From 1 February 2010, Manpower took over the provision of ADF recruiting services under an interim contract until March 2012.

6. In entering into the New DFR Contract each party could be expected to look after its own position. Defence constructed a contract which transferred a high level of risk to the contractor and CMG signed the contract in the full knowledge of the terms of the contract.⁶ Each party was responsible for

⁴ Manpower was Defence's prime contractor for recruiting services between July 2003 and 31 January 2009. On 1 February 2010, Manpower once again took over as the DFR prime contractor.

⁵ Minister for Defence Science and Personnel, Media Release 085/2008, *New Contract to Support ADF Recruiting*, 2 July 2008.

⁶ Cheshire and Fifoot's Law of Contract (Eighth Australian Edition, N.C.Seddon and M.P. Ellinghaus, pp. 627 and 652) draws attention to the necessity of holding a person who signs a document to that document, and states: 'it is simply not enough that a person who signed a document may have been confused, or may not have had a good or even adequate understanding of it.'

undertaking their own inquiries and assessing the implications for their ongoing operations of signing the New DFR Contract.

Audit objective and criteria

7. The objective of the audit was to assess whether Defence effectively managed the procurement process for services related to the recruitment of personnel to the ADF and the introduction of a new service provider. In addition to examining the procurement process itself, the audit specifically assessed whether Defence effectively managed the:

- seven month transition period (July 2008–January 2009) between the recruiting services contractors (Manpower and CMG); and
- contractual difficulties with CMG, including any operational impact, and the resolution of those matters to the extent that had occurred by the end of the audit.⁷

8. Originally, the audit approach was intended to have a broader scope that also included an examination of:

- Defence's management of performance monitoring frameworks for ADF recruitment; and
- the progress made in implementing major recruitment reforms for the better management of ADF candidates.

9. However, following Defence's advice to the ANAO during the early stages of the audit about unresolved commercial matters between Defence and CMG, the audit's scope was adjusted to take account of the changed circumstances.

10. The ANAO plans to include a further performance audit of ADF recruitment in its forward audit work program that will provide coverage of: DFR's performance monitoring frameworks; establishment of the Candidate Relationship Management Centre (CRMC), a major recruiting reform; Defence's management of the process to obtain an interim recruiting services

⁷ The audit generally did not examine matters that occurred after 2 October 2009—the date when Defence and CMG signed a termination deed for the recruiting services contract (see Chapter 5 for details)—including the arrangements to put in place alternative recruitment services. However, where there is updated data covering a more recent period or changes to key documents (such as the Termination Deed) the report takes account of this more recent material.

contractor (Manpower); and Defence's management of that contract and its planning for the future ADF recruiting services model.

Overall conclusion

11. The period since Defence and CMG signed the New DFR Contract on 2 July 2008 for the delivery of ADF recruiting services has been challenging for both parties. In transitioning to the management of the New DFR Contract, CMG faced a range of pressures in delivering the ADF recruiting services it had contracted to provide for the agreed price, particularly when also affected by the global economic downturn. For its part, Defence was bedding down a new recruiting service delivery model and transitioning to a new service provider for DFR services. As events unfolded, within the context of the New DFR Contract, Defence and CMG were unable to agree a way forward which CMG considered would allow it to successfully complete the five year contract for the delivery of DFR services while also meeting Defence's requirement that CMG deliver the contract in accordance with the agreed terms, including price, of the New DFR Contract.⁸

12. On 2 October 2009, Defence and CMG signed a Termination Deed in relation to the New DFR contract that, subject to a condition precedent being met,⁹ provided for CMG to cease providing DFR services from 1 February 2010. On 14 December 2009, Defence and Manpower signed a contract for Manpower to provide DFR services from 1 February 2010 until March 2012. Defence and its contractors have ensured that, throughout the disruptions of changing provider twice, only 12 months apart, the DFR recruiting process itself has continued to function on an uninterrupted basis.

13. Defence generally followed appropriate guidance in planning the tender process for the New DFR Contract and evaluating the proposals received from tenderers. However, aspects of the data and information underpinning the tender process, which had been provided to tenderers to inform their proposals, were not accurate or complete (for example,

⁸ As discussed in paragraphs 14 and 40, this was the case notwithstanding that Defence had been prepared to revise the New DFR Contract to the extent it considered was required to address certain issues in its conduct of the 2008 New DFR Contract tender process.

⁹ The condition precedent (clause 2 of the Termination Deed) was effectively that Defence had in place an alternative arrangement for the provision of DFR services from 1 February 2010. An amending deed was signed on 11 December 2009 which related to the termination of certain sub-contracts CMG had in place.

information on IT systems).¹⁰ During contractual negotiations, Defence sought to maintain a low level of risk exposure for the department and was successful in transferring certain key risks to CMG under the New DFR Contract. However, it is not clear that CMG had sufficiently priced its acceptance of these risks in signing the contract.

14. During the transition in period for the New DFR Contract, CMG raised a number of concerns with Defence (largely relating to costs that it had not anticipated). Defence informed the ANAO that, in the context of discussions with CMG about these matters, it suggested to the company that it prepare and submit to Defence a 'commercial plea' outlining its concerns, the basis for them and the remedies it was seeking.

15. Subsequently, CMG submitted a 'without prejudice' submission to Defence on 30 January 2009 which claimed that the New DFR contract did not reflect the commercial arrangement understood by the parties upon signing, and that the business and operations of DFR were not able to be understood by CMG prior to entering the New DFR Contract. CMG's 'without prejudice' submission also included examples of additional costs and liabilities CMG claimed it discovered during transition in (for example, 'make good' obligations under certain facility leases, relocation expenses on lease expiry, costs associated with meeting applicable security standards and the costs of rectifying existing IT infrastructure).

16. Adding complexity to the resolution of issues, Defence had concerns regarding the financial position of CMG and sought advice from its financial adviser regarding the financial viability of CMG. Defence continued to monitor CMG's financial position in the first part of 2009. CMG stated in a trading update (19 May 2009) to the Australian Stock Exchange that the financial outcome of the New DFR Contract was not in line with its original expectations. At the same time, Defence was aware of the effect of deteriorating global financial conditions on many sectors in the Australian economy and the impact that this would have on firms within the recruitment industry.

¹⁰ CMG informed the ANAO that it identified during the transition process that the operation of DFR in relation to personnel, facilities and IT was non-compliant with the applicable Defence security standards under the Defence Security Manual at the time of transition.

17. Once it became evident that there were serious differences between itself and CMG, Defence sought appropriate advice from its legal and financial advisors regarding the course ahead. Defence was careful in the negotiation of the Termination Deed not to countenance any claims by CMG clearly outside the original intent of the New DFR Contract and gave appropriate weight to the advice of its advisors.

18. In its 'without prejudice' submission of 30 January 2009, CMG made a broad claim for increased revenues (primarily through increased reimbursable costs) which, in accordance with the terms of the New DFR Contract, Defence rejected. In May 2009, CMG also claimed that weaknesses in the New DFR model itself (relating to the operation of the DSC and the new DFR system's inability to handle the number of inquiries being experienced) limited its ability to achieve 10 500 enlistments in a year.¹¹

19. During the course of 2009, another issue arose that would have had to be dealt with in relation to the terms of the New DFR Contract had it continued to operate. DFR recruiting targets were reduced and, currently, they are continuing to fall. This is chiefly as a result of significant improvements in both recruiting achievement and retention rates in the ADF, most probably due in part at least to the effects of the global economic crisis and Defence's enhanced recruitment and retention program.¹² Defence has ensured in its contracts with private sector providers that any decision as to the level of ADF recruiting targets is solely in the discretion of the department. However, the revenue available to CMG under the New DFR Contract was heavily reliant on the numbers of candidates to be recruited and did not provide the company with any protection in the event Defence reduced targets below that expected when the company tendered for this contract. In circumstances where retention rates are lower than desired, which had been the case for many years in the ADF, there is little risk that recruiting targets will be significantly reduced. However, in light of improved recruiting achievement and retention rates in the ADF during the latter half of 2009 and 2010, Defence has reduced recruiting targets.

¹¹ A target of 10 500 enlistments per year was the common scenario used in the 2008 tender process for assessing tender pricing and formed the basis on which tenderers submitted their bids.

¹² Defence informed the ANAO that the full time ADF separation rate as at 1 March 2010 was 7.2 per cent, compared with 9.9 per cent as at 1 March 2009. The average separation rate for full-time ADF members over the last five years is also 9.9 per cent.

20. By the time Defence was negotiating the Interim Contract it signed with Manpower in December 2009, the department had recognised the need to provide the contractor with some protection in the face of the prospect of reductions in ADF recruitment targets. The solution adopted in the Interim Contract was the adoption of a banded pricing approach which allows for the contractor to receive higher fixed and per head recruitment fees when Defence's recruitment target is less than 9500. In response to the proposed audit report, Defence noted that this issue did not eventuate during the period [preceding the mutual decision] to pursue an early termination of the contract, and Defence did not consider that this was a factor leading to CMG's 'without prejudice' submission. However, CMG informed the ANAO that, during negotiations with Defence subsequent to the submission of its 'without prejudice' submission and prior to the mutual decision to terminate the New DFR Contract, the company did raise with Defence the issue of the potential impact of falling recruitment targets on the revenue available under the New DFR Contract.

21. Noting that a mutual agreement between Defence and CMG to terminate the New DFR Contract would necessarily involve a range of costs for the department,¹³ an alternative option that Defence could have explored would have been for the Department to agree to provide CMG with some short term financial relief until a new tender for a replacement DFR contract, with different pricing arrangements, could be called. In explaining its course of action in not seeking to explore this option with CMG, Defence has indicated that it considers there was a real prospect that if CMG was to continue as DFR provider for the remainder of the New DFR Contract term, even under amended terms, that further performance issues and claims would arise, and there was a significant risk of the ultimate failure of the whole contract.¹⁴

22. Factors within the control of both parties contributed to the contractual difficulties encountered during transition to the New DFR Contract. As the impact of the global economic crisis deepened, some of these difficulties

¹³ Including any amounts agreed between the parties under the Termination Deed, transition in costs for a new provider and the likelihood that there would be a premium payable to obtain another provider for a shorter, interim contract.

¹⁴ Defence also informed the ANAO that it considered that:

such a variation to the contract would be likely to raise probity issues by changing the basis for the original value for money assessment made during a competitive tender process. This view is consistent with the advice Defence received from its legal advisers.

intensified. Defence did not have sufficient knowledge of key aspects of the contractual arrangements under the previous DFR contract with Manpower (for example, in relation to Information Technology and DFR premises). For its part, CMG has referred to a projected shortfall in revenue due to a lower level of recruits¹⁵ and a number of unanticipated costs contributing to a projected loss on the New DFR Contract for the year ended 30 June 2009.¹⁶ In early 2010, in explaining how this situation had developed, CMG informed the ANAO that it had not fully comprehended the risks it was assuming in signing the contract.

23. The cost to Defence of the early termination of the New DFR contract and bringing in an alternate supplier is expected to be \$12.1 million (excluding GST). In addition Defence will be paying a premium for DFR services over the next two years.¹⁷

24. The ANAO considers Defence could strengthen future DFR contracting processes by recognising in the contractual arrangements the mutual dependencies between Defence and the contractor, the areas of DFR performance that both the contractor and Defence contribute to and the need to make sure that risks transferred to the contractor are matters on which they could reasonably be expected to mitigate the impact of adverse events (for example, the appointment of key personnel and IT systems availability). Where factors affecting the operation of a contract require the 'management of uncertainty' (possibly involving changes to economic conditions or government policies), there is a case for the department to retain responsibility for managing such factors, or at least to frame its contractual arrangements such that the full impact of the uncertainty does not fall on its private sector partner to manage. The pricing elements of any future long term contract would benefit from the inclusion of a sliding scale for certain elements of contract pricing, based on different levels of recruitment targets.

¹⁵ Defence advice to the ANAO, dated 31 May 2010, noted that the lower level of recruits was: 'as a result (at the time) of reduced recruiting achievement, rather than a reduction in recruiting targets set by Defence'.

¹⁶ Chandler Macleod Group Limited, ASX Announcement *Trading Update – Core Business Performing Well in Tough Environment*, available from <http://www.asx.com.au/asxpdf/20090520/pdf/31hp5h3ld6mk3z.pdf> [accessed 21 October 2009].

¹⁷ Based largely on a calculation by Defence, the cost of services under the Interim Contract until March 2012 is approximately 15 per cent higher than Manpower's tendered price in 2008 and 20 per cent higher than CMG's tendered price in 2008 (see also paragraph 5.77).

25. Preparation for any future procurement should include making sure that data within material provided to tenderers is accurate and complete. Resolving differences in underlying data and information that become known after contract signature would be assisted by the introduction of a formal due diligence period.¹⁸ In addition, Defence must have sufficient in-house knowledge and expertise to support both the day-to-day and strategic ongoing management of DFR contracting arrangements.

Key findings by Chapter

Defence Force Recruiting Model (Chapter 2)

26. Fundamental to the operation of the New DFR model is collaboration between Defence and its prime contractor. The prime contractor and Defence both contribute to the overall recruitment process, which commences when a candidate makes their initial inquiry or application and concludes with their possible enlistment. Defence personnel undertake key interviews during the recruitment process and make final selection decisions.

27. In the six months to 31 December 2009, the average length of time taken to process applications for general enlistment was high (49 weeks compared to a target for 2009–10 of 6 weeks). The target was based on an efficiency measure put forward to Government by Defence in 2006, as part of a proposal to reduce the length of time taken for the recruitment process. However, the efficiency of the recruitment process was much worse in the last six months of 2009 (49 weeks) than in 2006 (30 weeks). Defence informed the ANAO that:

the period covered by this measure does not represent recruitment processing time only (which increased from 19 weeks to 23 weeks over the same period), and that a substantial increase in the number of enquiries received during 2008 and 2009, especially from uncommitted candidates, has extended processing times. Extended recruitment processing times have the potential to adversely affect candidates (and as [a] consequence, recruiting target achievement), the contractor's costs and Defence's interests. Despite the increase in recruitment processing times between 2006 and 2009, recruiting target achievement has increased significantly, whilst the average cost per recruit has been maintained

¹⁸ Australian National Audit Office, ANAO Audit Report No.11 2009–10, *Garrison Support Services*, Canberra, p. 47, refers to the use of due diligence periods by Defence in garrison support services contracts.

at 2006 levels. This suggests the current efficiency measure may need to be reviewed.¹⁹

28. Neither the New DFR Contract or the current Interim Contract, reflects the Key Performance Indicators (KPIs) that both Defence and the contractor contribute to (for example, recruitment performance) and those that are solely the responsibility of the contractor (for example, IT systems availability). The recruiting services contract would benefit from recognition being made within it of the KPIs to which Defence contributes.

29. Defence has ensured in its contracts with private sector providers of recruiting services that any decision as to the level of ADF recruiting targets is solely at the discretion of the department. However, the revenue available to CMG under the New DFR Contract was heavily reliant on the numbers of candidates to be recruited and did not provide the company with any protection in the event Defence reduced targets below that expected when the company tendered for this contract. A form of sliding scale in tenderer pricing for certain pricing elements, based upon different assumptions regarding the target levels of recruitment that Defence may set, would provide the necessary protection.²⁰ In addition, the New DFR contract did not incorporate a 'gain share' arrangement to help promote efficiencies and economies, including through innovation. Defence informed the ANAO that it was satisfied with existing continuous improvement provisions which already existed within the New DFR Contract. However, there is scope with future contracts for Defence to build on existing continuous improvement provisions and include a form of sliding scale for pricing in any longer term recruitment contracts as it has in the Interim Contract with Manpower.

New DFR Contract Procurement (Chapter 3)

30. The Commonwealth Procurement Guidelines (CPGs) form part of the procurement policy framework for all Australian government agencies and the Defence Procurement Policy Manual (DPPM) contains specific policy and guidance for Defence officials to refer to. Defence produced a comprehensive set of procurement planning documents for the new DFR tender process that

¹⁹ Defence advice to the ANAO dated 31 May 2010.

²⁰ The ANAO notes that Defence has recognised the need for a changed approach to pricing and the ADF Recruiting Services Interim Contract with Manpower (for services from February 2010 to March 2012) includes two pricing bands.

were consistent with the requirements contained in the DPPM and CPGs. Defence's actual conduct of the tender process was generally consistent with the requirements of the CPGs. However, Defence was not in a position to provide complete and accurate advice to tenderers, and was unable to respond fully to the tenderers' clarification questions during the Request for Tender (RFT) process (see paragraphs 3.27 and 3.28). Some of the matters which related to this weakness in the tender (for example, in relation to DFR premises and IT systems) were factors within the contractual issues that arose between Defence and CMG later in 2008–09 (see Chapters 4 and 5 for details).²¹

31. The Invitation to Register Interest (ITR) evaluation plan and evaluation report were consistent with the ITR documentation released by Defence. Similarly, the RFT evaluation plan and the Preliminary Source Evaluation Report (PSER) were consistent with the RFT documentation released by Defence to the tenderers.

32. Defence identified a number of financial risks for the Commonwealth associated with the New DFR procurement and acted to mitigate those financial risks during the tender process. However, the RFT evaluation would have benefited from analysis of the sensitivity of tenderers' bids to the impact of potential decisions by Defence over the term of the contract to vary recruitment targets to take account of changes in the ADF's requirements, and the risks such potential changes presented for Defence and any contractor. Any sensitivity analysis could also have examined the impact on tenderers' pricing proposals of variations in their success in meeting recruitment targets from the levels assumed in their tender. Such considerations could have informed decisions on the final terms of the contract.

33. The contractual negotiations were generally completed within Defence's estimated timeframe for contract signature and were consistent with the content and guidance in the approved contract negotiation directive (see paragraphs 3.69 to 3.72). During the contractual negotiations, Defence sought to maintain a low level of risk exposure under the contract. Defence was successful in transferring certain key risks to CMG, although it is not clear whether CMG had sufficiently priced its acceptance of these risks in signing the contract. In designing a contract and pursuing contract negotiations it is

²¹ Defence informed the ANAO in response to the proposed audit report of its view that: 'Defence offered to effectively mitigate the financial impact of these weaknesses through the commercial plea process it initiated with CMG'. Defence advice to the ANAO dated 31 May 2010.

important to recognise that assigning risks to a contractor without it being in a position to properly mitigate these risks, and thus reduce their likelihood of coming to fruition, is likely to affect the contractor's pricing approach, and potentially a contract's viability if not effectively priced by the contractor.

Managing Contract Transition (Chapter 4)

34. Defence's general approach to the transition period between contractors was consistent with sound practice for managing a transition phase in contracts, including the importance of ensuring a smooth transition, establishing relationships, systems and procedures, and transferring information and assets between contractors.²² Defence made payments to CMG during the transition period from July 2008 to January 2009 in accordance with the New DFR Contract.

35. Of the issues that arose during the transition period, the two most challenging for Defence to manage were those surrounding DFR's IT systems and facilities' arrangements.²³ A lack of sufficiently rigorous preparation activities by Defence to finalise all of the obligations and rights existing under the then DFR contract with Manpower, and in preparation for the tender, contributed to the severity of the issues that arose.

36. The Director-General, Defence Force Recruiting (DGD FR) (the ADF head of DFR) changed on 3 July 2008 (one day after signature of the New DFR Contract) and again on 1 February 2010 (when Manpower re-commenced providing DFR services). The impact of the posting cycle on senior ADF management poses particular risks for Defence that require careful management. In addition, CMG announced the appointment of a new Managing Director and Chief Executive Officer on 3 July 2008, the day after the New DFR Contract was signed. As a consequence, both parties to the contract had changed their senior leadership between the tender submission, assessment and contract negotiation period, and the period during which CMG undertook transition towards contract management.

²² Australian National Audit Office and Department of Finance and Administration, *Better Practice Guide—Developing and Managing Contracts*, February 2007, ANAO, Canberra, p. 79.

²³ For example, as noted in footnote 10, CMG informed the ANAO that it identified during the transition process that the operation of DFR in relation to personnel, facilities and IT was non-compliant with the applicable Defence security standards under the Defence Security Manual at the time of transition.

37. At the end of the seven month transition period on 1 February 2009, when CMG assumed full responsibility for the delivery of services under the New DFR Contract, a number of significant issues remained unresolved in addition to the ongoing issues with the IT systems and facilities. As a result, it was not until September 2009, eight months after the formal handover between the contractors, that all transition period activities were considered by Defence to have been completed. Some of the underlying issues were ultimately dealt with in the context of the termination of the New DFR Contract. If the New DFR Contract had provided for a formal due diligence period (as do some other Defence contracts for the provision of services), Defence would have been better placed to deal with these issues in a timely and planned manner. Such a provision would allow for limited revisions to be made to costing and pricing arrangements in the light of factors not known at the time of contract signature.²⁴

38. During the transition period from July 2008 to January 2009, recruitment target achievement varied from 68 per cent to 80 per cent. In an earlier comparable period, July 2007 to January 2008, target achievement varied between 76 per cent and 90 per cent. However, there were no breaks in the delivery of DFR services during the transition period.

Termination of the Recruitment Services Contract (Chapter 5)

39. On 30 January 2009, CMG made a 'without prejudice' submission to Defence which claimed that the New DFR contract did not reflect the commercial arrangement understood by the parties upon signing, and that the business and operations of DFR were not able to be understood by CMG prior to entering the New DFR Contract.²⁵ CMG's 'without prejudice' submission also included examples of additional costs and liabilities (related to matters such as facilities, security and IT) which CMG claimed it discovered during transition in. After some months of discussions on the matters raised in CMG's submission, Defence and CMG agreed to discussions on mutually terminating

²⁴ In May 2010, Defence commented in response to the ANAO's proposed audit report that: 'It should be noted that the commercial plea process initiated by Defence achieved largely the same outcome as would have been provided under a post-contract-signature due diligence period'.

²⁵ As noted in paragraph 14, Defence informed the ANAO that, in the context of discussions with CMG about the company's concerns that arose during the transition in period, the department suggested to the company that it prepare and submit to Defence a 'commercial plea' outlining its concerns, the basis for them and the remedies it was seeking. CMG's 'without prejudice' submission was provided in response to this suggestion.

the New DFR Contract. The two parties signed a Termination Deed on 2 October 2009 and an Amending Deed on 11 December 2009.

40. Notwithstanding the weaknesses that existed in the original tender processes (see paragraph 30), Defence adopted a prudent response to the 'without prejudice' submission from CMG. Weaknesses in the original tender process resulted in Defence having to make additional financial commitments to the operation of the New DFR arrangements. Matters that Defence considered as part of this process included the need to ensure the ongoing provision of recruiting services, deficiencies in the data supporting the original tender process, and the need to maintain the integrity of the original tender and its assessment. Defence rejected the claim by CMG that the contract be amended to include a broad provision for the reimbursement of costs incurred in providing DFR services. As a consequence of its overall consideration of CMG's 'without prejudice' submission, Defence agreed to meet additional costs totalling \$1.6 million (excluding GST). In the end, payment for these costs formed part of the termination payment.

41. Performance of the recruitment process in the first part of 2009, in terms of achievement against target, was not at a level that was anticipated by Defence during the tender process. Factors affecting this situation were the increased level of interest in joining the ADF during 2009, and the resultant difficulties in managing the recruitment pipeline. To the extent possible, within the constraints of the New DFR Contract, Defence took steps to help improve the performance of the recruitment process through providing additional CRMC staff and also through the short term use of additional ADF staff in the DFRCs. Defence also met certain other leasing costs associated with office space in Melbourne. In the second half of 2009, CMG's recruitment performance against target was considerably improved. The recruitment target for the seven months to 31 January 2010 was 7.3 per cent less than the target for the comparable period 12 months earlier,²⁶ although the actual number of enlistments (excluding Gap Year entry) grew by 558 in the more recent period.

42. Defence was careful in the negotiation of the termination deed not to countenance any of the claims made by CMG that clearly were outside the original intent of the New DFR Contract. From the available evidence, Defence also gave appropriate weight to the views of its legal advisers that were

²⁶ The recruitment target for the seven month period in 2008–09 was 5781 and for the same period in 2009–10 was 5359.

involved on a regular basis throughout the negotiation of the termination. Nevertheless, Defence has had to make payments of \$12.1 million (excluding GST) associated with the termination arrangements and to put in place an alternative provider.²⁷

43. An amount of \$8.2 million (excluding GST) of this \$12.1 million (excluding GST) relates to transition in payments made to Manpower in respect of the Interim Contract (under which it assumed responsibility for providing full DFR recruiting services from 1 February 2010). The transition in payments to Manpower included \$3.1 million (excluding GST) related to the work of sub-contractors engaged by Manpower to deliver certain services for DFR during the period 21 December 2009 to 31 January 2010. Under the New DFR Contract, CMG was also paid for the delivery of these services over this period as part of the fees paid even though Manpower had assumed responsibility for delivery by the sub-contractors. Accordingly, to facilitate the termination of the New DFR Contract and transition in of its interim provider, Defence has effectively paid twice for certain services between 21 December 2009 and 31 January 2010.

44. As part of the resources used in the management of the transition in of CMG, ongoing management of the New DFR Contract and the arrangements for the transition out of CMG, Defence has been reliant on the services of consultants to undertake key day-to-day tasks. This heavy reliance on external consultants is an issue to be managed by Defence to ensure it has sufficient in-house knowledge and expertise within its in-house resources to satisfactorily manage the DFR contractual arrangements.

Responses to the proposed report

45. In addition to providing a copy of the proposed report to Defence for comment, the ANAO also provided the proposed report to CMG, and a relevant extract to Manpower, for comment. Neither company elected to provide substantive comments for publication in the final audit report. However, CMG's views have been reflected as requested at relevant points in the Summary and body of the report.

²⁷ Of this \$12.1 million, \$1.6 million related to lease and fit-out costs which were elements of CMG's 'without prejudice' submission, that Defence agreed to meet (see paragraph 40).

46. Defence's detailed responses to each of the audit's six recommendations are set out in the body of the report underneath the relevant recommendation. Defence also provided the following overall response to the proposed audit report:

Defence welcomes the ANAO audit report on *Contracting for Defence Force Recruiting Services*. This audit examined a period where Defence Force Recruiting was managing an unusual set of circumstances, including: the major procurement of a prime contractor to deliver a new recruiting service delivery model; the subsequent impact of the Global Financial Crisis both on the recruitment sector and Defence Force Recruiting; a request by Defence's prime contractor to terminate their contract during its first year of operation; and the subsequent procurement of, and transition to, an interim contract arrangement.

There have been a number of lessons for Defence throughout this period and action has already commenced to implement the ANAO's recommendations. Defence notes that during this challenging period its highest priority has been to ensure that recruiting operations were not adversely affected. Despite the contractual difficulties, in 2009–10 Defence delivered the highest levels of recruiting target achievement in more than a decade. Through the Audit process, Defence has been able to identify areas that will assist increasing recruiting performance as well as informing improved practices that will be used in future contract arrangements.

Recommendations

Recommendation No 1

Para 2.24

The ANAO recommends that Defence implements necessary improvements in the efficiency of recruitment processes, including candidate processing times from receipt of an application to issuing a Letter of Offer, to the extent such actions deliver cost-effective improvements in overall recruiting outcomes.

Defence response: Agreed.

Recommendation No 2

Para 3.35

The ANAO recommends that, for any future Defence Force Recruiting services contract tenders, Defence undertakes sufficient preparation for the tender process so as to be in a position to provide tenderers with readily accessible, complete and accurate data to allow tenderers to make properly informed tender responses.

Defence response: Agreed.

Recommendation No 3

Para 3.97

The ANAO recommends that Defence includes access provisions in its major Defence Force Recruiting contracts to enable access by the ANAO to prime and subcontractors' records and premises for audit purposes.

Defence response: Agreed.

**Recommendation
No 4**

Para 4.48

The ANAO recommends that for any future DFR contract Defence include a formal due diligence period as part of the contract, where such an approach is consistent with the overall contract model, risk framework, and objectives for the contract.

Defence response: Agreed.

**Recommendation
No 5**

Para 4.68

In view of the benefits from continuity in the role of Director-General, Defence Force Recruiting Branch during critical stages in the ongoing management of Defence Force recruiting contracts, the ANAO recommends that Defence plans its rotation of senior ADF personnel through this position to minimise disruption at critical stages of the contracting cycle.

Defence response: Agreed with qualification.

**Recommendation
No 6**

Para 5.12

As part of any decision on Defence's future approach to Defence Force Recruiting, the ANAO recommends that Defence reviews the level of in-house capability it requires to effectively undertake the ongoing contract management responsibilities associated with any outsourced option that may be adopted.

Defence response: Agreed.

Audit Findings and Conclusions

1. Introduction

This chapter provides a description of Australian Defence Force recruitment and explains the audit approach and structure of the report.

Background

1.1 Fundamental to maintaining and building Australian Defence Force (ADF) capability is the ongoing task of recruiting the required numbers of personnel with the right skills, abilities and/or potential to carry out the ADF's mission.²⁸ In May 2009, the Department of Defence (Defence) issued a new Defence White Paper—*Defending Australia in the Asia Pacific Century: Force 2030*²⁹—which noted: 'Attracting and retaining the future workforce will be one of the most significant challenges facing Defence' and identified specific single Service initiatives to meet ADF workforce requirements.³⁰

1.2 Defence force recruitment is a major undertaking given the size of the ADF (some 55 081 permanent and 20 277 Reserve personnel as at 30 June 2009),³¹ the diverse range of personnel required by the three Services—the Navy, the Army and the Air Force, and the fact that Defence must compete with Australian business and industry to attract the required recruits, both skilled and unskilled.³² It also involves the application of significant resources, with Defence's annual expenditure on the recruiting function amounting to \$154.8 million in 2008–09 and involving approximately 700 personnel

²⁸ Incorporating the ADF, the Department of Defence's mission is: 'to defend Australia and its national interests'. Department of Defence, *Annual Report 2008–09*, Defence, Canberra, 2009, Volume 1, p. 41.

²⁹ The Defence White Paper is a key planning document for Defence's future in that it sets out the Government's future plans for Defence, how it will achieve those plans, and the level of resources the Government is planning to invest in Defence.

³⁰ Department of Defence, *Defending Australia in the Asia Pacific Century: Force 2030*, Defence, Canberra, 2009, p. 113.

³¹ The ADF comprises Navy (13 182 permanent and 2 032 Reserves); Army (27 833 permanent and 15 473 Reserves); and Air Force (14 066 permanent and 2 772 Reserves). In 2008–09 the actual average funded strength for ADF permanent members was 55 081. Department of Defence, *Annual Report 2008–09*, Defence, Canberra, 2009, Volume 1, pp. 27–28.

³² The ADF recruitment priority areas include officers, health professionals and technical trades. To join the ADF you must: be an Australian citizen or a permanent resident eligible for Australian citizenship; be aged from 17–55 years; pass specific medical and physical standards; and meet the minimum educational standards for your chosen job.

(including Australian Public Service (APS), ADF and civilian contractor staff) (see Figure 1.1).³³

1.3 In 2006, the then Government allocated approximately \$3.1 billion over 11 calendar years for recruitment and retention measures with the aim of achieving an increase in the size of the full-time military workforce in the ADF to 57 000 personnel by 2016.³⁴ The 2009 Defence White Paper increased this target by approximately 800 full-time ADF personnel to 57 800 by 2019.

1.4 Defence manages the recruitment function for the ADF through the Defence Force Recruiting (DFR) Branch. The DFR Branch's mission is described as:

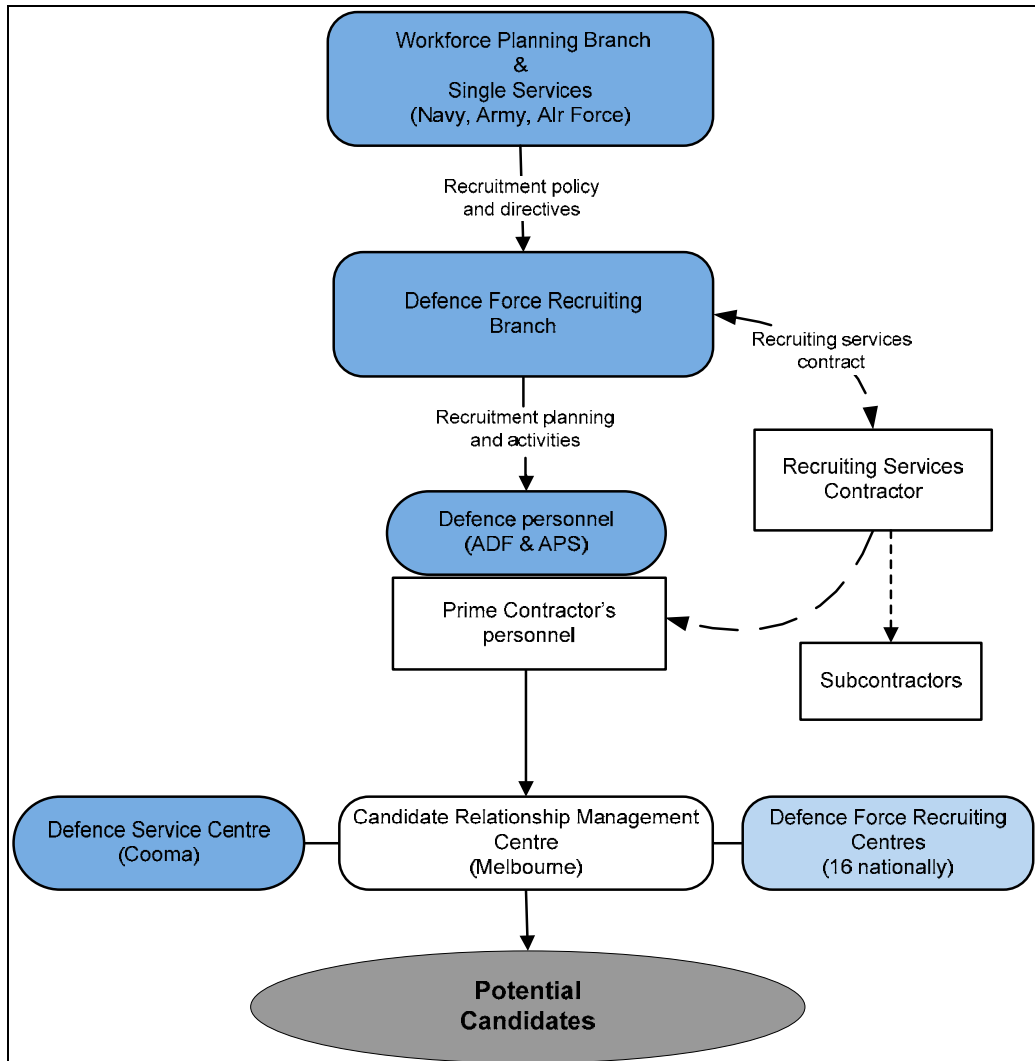
As a key component of the ADF Recruiting System, Defence Force Recruiting recruits the right people in the right numbers at the right time by focusing on the needs of the ADF and our candidates.³⁵

1.5 Figure 1.1 illustrates the major components of the ADF recruitment system.

³³ The primary delivery mechanism for defence force recruitment is via a public/private sector collaboration between Defence and a private sector company to deliver recruiting services to the ADF. Total expenditure by the Defence Force Recruitment Branch in 2008–09 (comprising civilian Defence employee expenses, military employee expenses and all suppliers' expenses) was \$154.8 million.

³⁴ The funding was announced in December 2006 and as part of the 2007–08 Federal Budget. Department of Defence, *Annual Report 2006–07*, Defence, Canberra, October 2007, Volume One, p. 124. Some \$496 million of this \$3.1 billion related to the reform of the recruiting model (see paragraph 0).

³⁵ Department of Defence, DFR Recruiting Plan 2008–09, p. 3.

Figure 1.1**Australian Defence Force recruitment system**

Source: ANAO analysis, 2010.

1.6 As shown in Figure 1.1, DFR Branch delivers recruitment services to the ADF with the assistance of a prime recruiting services contractor (the Prime Contractor); a range of subcontractors to the Prime Contractor; and the Defence Support Group, which provides the Defence Service Centre (DSC) (a

call centre in Cooma).³⁶ Recruitment directives (targets) are developed by Defence to meet future ADF capability requirements. DFR Branch aims to meet these targets under a single, major contract that provides for recruiting services to be delivered by 16 Defence Force Recruiting Centres (DFRCs) (jointly staffed by both personnel employed by the prime contractor and ADF personnel) and a dedicated Candidate Relationship Management Centre (staffed by the prime contractor's personnel),³⁷ with the support of the DSC operated by DSG personnel.

1.7 As at 10 March 2010, Defence employed 232 full-time ADF personnel and 26 Defence Australian Public Service (APS) personnel to deliver Defence Force Recruiting (DFR); and Manpower Services (Australia) Pty Ltd (Manpower), the current prime contractor, employed an additional 330 permanent and 113 casual or contract personnel. The DSC employs around 72 full-time and nine part-time APS personnel to manage a range of call centre activities for Defence, including initial call reception for Defence Force Recruiting. The number of stakeholders involved in delivering defence force recruitment services, and shared responsibilities, adds to its complexity from a management and resourcing perspective.

Delivering ADF recruitment services

History

1.8 Recruiting for the ADF was traditionally managed internally by Defence personnel. In 1997, following the Defence Efficiency Review, Defence recruitment moved from being solely administered by Defence personnel into

³⁶ With Defence's agreement, a Prime Contractor may engage a range of subcontractors in order to deliver the full range of services required by Defence under the DFR contract (for example, marketing, medical and IT services). The Defence Service Centre in Cooma, New South Wales, provides a range of call centre functions for Defence, including for Defence Force Recruiting, and is the initial point of contact for over 40 per cent of all enquiries from people seeking information about careers in the ADF. The arrangement is underpinned by a Service Level Agreement between the Defence Support Group and the Defence Force Recruiting Branch.

³⁷ A dedicated Candidate Relationship Management Centre (CRMC) was established in Melbourne to actively support candidates through the ADF recruiting process. Defence's expectation in introducing the CRMC was, among other activities, to provide greater efficiencies and improve the recruitment process by enabling regular contact between potential candidates, ADF personnel and DFR staff. Department of Defence, 2007, *ADF Recruiting Strategic Plan 2007–17*, p. 31.

a collaboration between Defence and Manpower Services (Australia) Pty Ltd (Manpower).³⁸

1.9 In 2003, DFR, consisting of Defence personnel (ADF and APS) and personnel from Manpower, was set up to provide integrated recruitment services for the ADF.³⁹ From July 2003, Manpower provided recruiting services in collaboration with Defence until January 2009.⁴⁰ The total cost of this initial recruiting services contract, including transition (see footnote 38), was \$331.7 million.⁴¹

1.10 In 2005, Defence established a dedicated DFR Branch, with its main objectives being: 'to develop a long term Recruiting Strategy and enhance recruiting operations for the ADF'.⁴²

1.11 In 2006, under the provisions of the DFR contract then in place, Defence contracted an external consultant to evaluate the first three years of operation of the DFR contract in terms of the model's suitability and performance.⁴³ The evaluation concluded that the collaborative model was sound, but did not fully meet the current needs of the ADF, and would not meet future recruitment needs without significant changes being made. However, the basis for this conclusion is not fully documented in the consultant's evaluation report. To support the claim in the evaluation report that the collaborative outsourced delivery model for DFR had delivered cost efficiencies compared to the previous model of direct delivery of DFR by Defence, the report includes only one quantified example of such a cost efficiency.

³⁸ In September 2000, following a competitive tendering process, Defence entered into an outsourcing contract with Manpower for the delivery of ADF recruitment services. Initially, two trials were conducted before Defence signed a national service delivery contract with Manpower in November 2002. After a transition period from November 2002–30 June 2003, Manpower provided national ADF recruitment services to Defence from 1 July 2003 to 31 January 2009. Australian National Audit Office 2003, *Australian Defence Force Recruiting Contract*, Audit Report No.10, 2003–04, ANAO, Canberra, p. 11 and pp. 26–28.

³⁹ Australian National Audit Office, ANAO Audit Report No.10 2003–04, *Australian Defence Force Recruiting Contract*, Canberra, p. 11.

⁴⁰ Manpower Services (Australia) Pty Ltd is referred to in this report as the Previous Contractor.

⁴¹ This covered services provided in the period November 2002 to January 2009.

⁴² Department of Defence, *The New DFR Design Blueprint*, March 2008, p. 7.

⁴³ Department of Defence, *New DFR Recruiting Services Contract, Request for Tender, Part 2 – Information Provided to Requestors*, p. 9.

1.12 In late 2006, the ADF Chiefs of Service Committee and the then Minister for Defence supported a new approach to the ADF's recruiting capability that took account of the evaluation's findings.⁴⁴ The then Government agreed to the proposed reform of DFR and implementation of a new DFR model (New DFR) in early December 2006.⁴⁵ Subsequently, Defence developed a strategy to implement the recommendations of the 2006 evaluation of the delivery of DFR services.⁴⁶

New recruitment model

1.13 Defence began working with Manpower on implementing the New DFR model during 2007–08. At the same time, the department was also undertaking an open tender process for a contractor to deliver recruiting services into the future under the New DFR Recruiting Services Contract (the New DFR Contract).⁴⁷ The changes to the service delivery model were incorporated into the New DFR Contract and the model was fully implemented nationally by 20 November 2008, by which time the successful tenderer had commenced a transition in period ahead of taking over responsibility under the New DFR Contract for the delivery of recruiting services for the ADF.

⁴⁴ The committee's permanent members include: Chief of the Defence Force (Chair); Secretary of the Department of Defence; Vice Chief of the Defence Force; Chief of Navy; Chief of Army; and Chief of Air Force.

⁴⁵ The key principles of the New DFR were:

- a candidate focused process;
- ADF personnel directly involved with career promotions, advice and selection roles;
- maximising economies of scale;
- flexible and reliable information technology systems; and
- clear lines of accountability for the performance of allocated functions, linked with measurable key performance indicators.

Department of Defence, *New DFR Recruiting Services Contract, Request for Tender, Part 2 – Information Provided to Requestors*, p. 10.

⁴⁶ Defence developed *The New DFR Design Blueprint* to guide the delivery of the improved ADF recruiting capability approved by the Government in December 2006. *The New DFR Implementation Plan* detailed the activities, timelines, resources and parties responsible for implementing the action items in the Design Blueprint, including delivering the New DFR contract.

⁴⁷ See Chapter 3 for a discussion of the tender process.

1.14 On 2 July 2008, Defence signed a contract with the successful tenderer, the Chandler Macleod Group (CMG).⁴⁸ From 1 February 2009, following a seven month transition period, CMG took over the provision of ADF recruiting services. The contract was for a five year term ending on 1 February 2014. In July 2008, the then Minister for Defence, Science and Personnel announced that the total estimated cost of this contract over its five year term would be up to \$405 million.⁴⁹ However, Defence and CMG agreed in October 2009 to the early termination of the contract after only 9 months of operation, subject to the satisfaction of certain conditions. In an Australian Stock Exchange announcement on 16 September 2009, CMG provided the following explanation for this:

After the transition-in process we discovered the contract was unable to deliver the revenue outcomes we had anticipated and we also discovered a number of costs which were previously unanticipated. The impact of these developments was a contract which was no longer commercially viable to Chandler Macleod. We worked closely with [Defence] to identify changes which might reverse this outcome, however, ultimately the most practical course of action was to terminate the contract on agreed terms.

1.15 The issues that led to the termination of the New DFR Contract, Defence's management of them, the negotiation of the termination deed and the steps Defence took to ensure that ADF recruitment action remained ongoing at the required levels—notwithstanding the problems encountered with the New DFR Contract—are discussed in Chapters 4 and 5.

1.16 CMG ceased to provide DFR services from 1 February 2010. On 14 December 2009 Defence signed what it termed an interim contract with Manpower to provide ADF recruiting services from 1 February 2010 until March 2012.

⁴⁸ The Chandler Macleod Group is referred to in this report as the Prime Contractor. The Prime Contractor sub-contracted to the Daemon Group the provision of marketing services, to the Corporate Health Group the provision of medical services, and to EDS the provision of information and communication technology services for DFR.

⁴⁹ Minister for Defence Science and Personnel, Media Release 085/2008, *New Contract to Support ADF Recruiting*, 2 July 2008.

Previous reports

1.17 The recruitment of ADF personnel, and associated retention activity, has been the subject of a number of reports. In October 2001, the Senate Foreign Affairs, Defence and Trade References Committee published a report, *Recruitment and Retention of ADF Personnel*, which looked at whether the then recruitment and retention strategies of the ADF were effective in meeting the organisation's personnel requirements.⁵⁰

1.18 In several of ANAO performance audits of Defence, the issue of ADF recruitment has been included as part of a broader audit scope.⁵¹ Specifically in relation to ADF recruitment, the ANAO audited the initial DFR contract with Manpower in Audit Report No.10 2003–04, *Australian Defence Force Recruiting Contract*. More generally, the ANAO has also published Audit Report No.31 2007–08, *Management of Recruitment in the Australian Public Service*.⁵² The ANAO has considered the relevant findings and recommendations from those audit reports in undertaking this audit.

1.19 Additionally, the ANAO has considered international reports on military recruitment and retention published in 2006 by the Office of the Auditor General of Canada and the National Audit Office in the United Kingdom.⁵³

⁵⁰ The report concluded that, although general enlistments had increased statistically, the recruiting system at the time was not meeting ADF recruiting targets and included 31 recommendations to improve the recruiting process and organisation. Commonwealth of Australia, 2001, Report of the Senate Foreign Affairs, Defence and Trade References Committee, *Recruitment and Retention of ADF Personnel*, Chapter 7, paragraph 7.3.

⁵¹ Recent examples include ANAO Audit Report No.31 2008–09, *Army Reserve Forces* and ANAO Audit Report No.23 2008–09, *Management of the Collins-class Operations Sustainment*, which both contained findings on ADF recruitment.

⁵² The audit assessed whether APS agencies had sound approaches to recruitment to assist them in providing the workforce capability to deliver government programs effectively. The audit analysed Australian Public Service Commission recruitment and survey data covering all agencies and completed a detailed assessment of three separate APS agencies.

⁵³ Office of the Auditor General of Canada, *Status Report of the Auditor General of Canada* [Internet]. Office of the Auditor General of Canada, Canada, 2006, available from <http://www.oag-bvg.gc.ca/internet/English/parl_oag_200605_02_e_14959.html> [accessed 12 October 2009]. National Audit Office, *Recruitment and Retention in the Armed Forces* [Internet]. NAO, United Kingdom, 2006, available from <http://www.nao.org.uk/publications/0506/recruitment_and_retention_in_t.aspx> [accessed 12 October 2009].

Audit objective and approach

1.20 The objective of the audit was to assess whether Defence effectively managed the procurement process for services related to the recruitment of personnel to the ADF and the introduction of a new service provider. In addition to examining the procurement process itself, the audit specifically assessed whether Defence effectively managed the:

- seven month transition period (July 2008–January 2009) between the recruiting services contractors (Manpower and CMG); and
- contractual difficulties with CMG, including any operational impact, and the resolution of those matters to the extent that had occurred by the end of the audit.⁵⁴

1.21 Originally, the audit approach was intended to have a broader scope that also included an examination of:

- Defence’s management of performance monitoring frameworks for ADF recruitment; and
- the progress made in implementing major recruitment reforms for the better management of ADF candidates.

1.22 However, following Defence’s advice to the ANAO during the early stages of the audit about unresolved commercial matters between Defence and CMG, the audit’s objective and scope was adjusted to take account of the changed circumstances.⁵⁵

1.23 The ANAO conducted fieldwork for the audit between March 2009 and October 2009 at DFR offices in the Australian Capital Territory.⁵⁶ The fieldwork involved collecting documentary evidence and meetings with key personnel in DFR. The audit team also conducted interviews with the three tenderers who

⁵⁴ The audit generally did not examine matters that occurred after 2 October 2009—the date when Defence and CMG signed a termination deed for the recruiting services contract (see Chapter 5 for details)—including the arrangements to put in place alternative recruitment services.

⁵⁵ The outcome and date for resolution of the commercial matters was uncertain throughout most of the fieldwork stage of the audit. At the time of varying the audit’s scope, July 2009, Defence anticipated resolution of the commercial matters in August 2009. In the end, some of these matters were only resolved in the Termination Deed of October 2009 (later amended in December 2009) and the payments flowing from that Deed.

⁵⁶ From March 2009 to October 2009, the ANAO’s ability to undertake routine fieldwork was affected by the ongoing nature of commercial discussions between Defence and the Prime Contractor.

participated in the 2007–08 ‘New DFR Contract’ tender process to gather their views on Defence’s conduct of that tender process.

1.24 Due to the contractual matters that arose, it was not practicable for the ANAO to undertake during this audit the planned detailed examination of DFR’s performance monitoring frameworks or establishment of the CRMC (a major recruiting reform). The ANAO intends to include a further performance audit of ADF recruitment in its forward audit work program that will provide coverage of these issues, Defence’s management of the process to obtain an interim recruiting services contractor (Manpower), Defence’s management of that contract and its planning for the future ADF recruiting services model.

1.25 The audit was conducted in accordance with ANAO auditing standards at a cost to the ANAO of approximately \$360 000. Pat Farrelly and Associates Pty Ltd provided the ANAO with assistance in the conduct of the audit.

Report structure

1.26 Following this introductory chapter, the remainder of the report is presented in four chapters:

- Chapter 2: Defence Force Recruiting Model;
- Chapter 3: New DFR Contract Procurement;
- Chapter 4: Managing Contract Transition; and
- Chapter 5: Termination of the Recruitment Services Contract.

2. Defence Force Recruiting Model

This chapter describes and discusses the operation of the Defence Force Recruiting model.

Introduction

2.1 As discussed in Chapter 1, the ADF recruitment system is underpinned by a collaboration between Defence and a private sector company. In 2003, Defence Force Recruiting (DFR), consisting of Defence personnel (ADF and APS) and personnel from Manpower, was set up to provide integrated recruitment services for the ADF. In this chapter, the service delivery model for recruitment services for the ADF, known as the 'New DFR' service delivery model, which underpinned Defence's contract with CMG is described and discussed in more detail, particularly:

- the roles and responsibilities of the parties in the public/private sector collaboration; and
- contract pricing.

2.2 In addition, the chapter discusses the performance of Manpower under the previous recruiting services contract and of CMG under the New DFR Contract, the current performance measurement framework and future options for the DFR model.

Roles and responsibilities

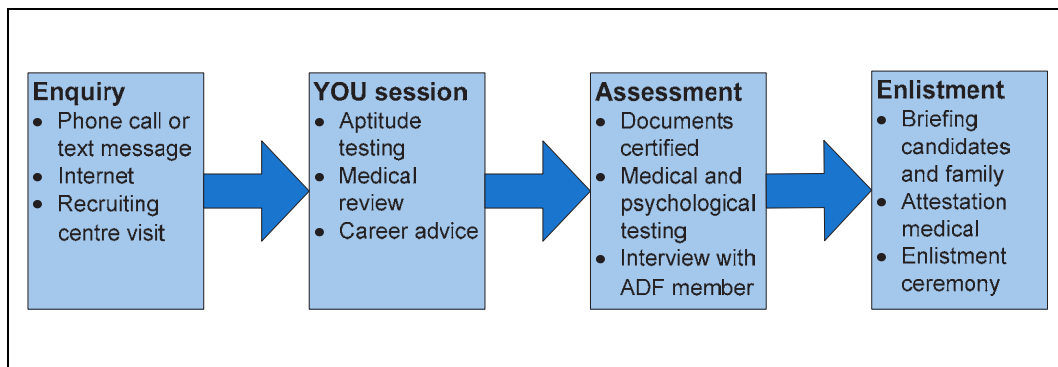
2.3 The New DFR Contract defined the roles and responsibilities of the parties—Defence and CMG.

2.4 Essentially, under the collaborative New DFR Contract, CMG was responsible for attracting and managing ab initio candidates (new, without prior service experience) and prior service candidates for employment with the ADF through: ADF marketing and branding activities; medical and psychological testing and assessment; and delivery of management,

coordination, administrative and information technology support to recruiting activities.⁵⁷

Figure 2.1

Australian Defence Force candidate recruitment process



Note: 'YOU' is an acronym for 'Your Opportunities Unlimited'.

Source: ANAO analysis, 2009.

2.5 Figure 2.1 outlines the current ADF recruitment process. This is a joint process between Defence and its prime contractor, with the contractor undertaking the substantial part of the recruitment operation. Defence plays important roles in the joint recruitment process, primarily through:

- receiving enquiries at the Defence Service Centre (a call centre in Cooma, NSW);
- ADF personnel undertaking career advice interviews;
- ADF personnel final assessment interviews; and
- conduct of Officer Selection Boards by the ADF.

2.6 Defence informed the ANAO that in 2006–07 the median processing time between initial interview (YOU session) to the issue of a letter of offer was 133 days.⁵⁸ In comparison, Defence's *Australian Defence Force Recruiting Strategic Plan 2007–17* stated that the average time taken for enquiry to

⁵⁷ Prior service candidates are those with military service in either the Reserve Forces, another Service, another nation, previous permanent ADF member or transferred from the ADF Gap Year. The ADF Gap Year is a Government initiative, launched in 2007, to encourage 17–24 year olds who have completed Year 12 secondary education in the previous two years to join the ADF for 12 months. The single Services also separately process inter- and intra-service transfers.

⁵⁸ This relates to a segment within the complete period between enquiry and enlistment. The efficiency measure referred to in Table 2.1 relates to the total time taken from enquiry to enlistment.

engagement using the private sector's benchmark was 42 days.⁵⁹ The longer it takes to complete the recruitment process the greater the potential to lose candidates and the more resources are consumed in managing the process.

2.7 The conduct of the recruiting process for the ADF under the current DFR model is a collaborative undertaking that is reliant upon Defence and the prime contractor performing their respective roles while ensuring regular contact is maintained with the candidate throughout the recruitment process. The prime contractor receives a fixed payment per candidate upon enlistment, which provides a clear incentive for the contractor to maximise the number of candidates that ultimately enlist.

An example of collaboration

2.8 One example of the collaborative aspects of the model in operation can be seen in the joint response by Defence and CMG to increased enquiries from the public in late 2008 and early 2009. Defence recorded an increase in recruitment enquiries and applications in late 2008 through to early 2009.⁶⁰ The enquiry rate for the three months from 31 October 2008 to 31 January 2009 was 24 842, a 51 per cent increase relative to the same period in 2007–08.⁶¹ The enquiry rate in 2008–09 included active and passive inquiries (showed initial interest). The number of applications received during that period also increased from 4 192 to 4 466, an approximately 7 per cent increase relative to the same period in 2007–08.

2.9 The conversion ratio (enquiry:application:enlistment) increased from 9:2:1 to 11:5:1 between December 2008 and March 2009. In response to the increase in enquiries, Defence proposed to increase the number of ADF personnel for the YOU session and assessment components of the recruitment process to address key points where the flow of potential recruits can be delayed. CMG also sought to remove inactive applications from the pipeline and improve initial candidate filtering.

⁵⁹ Department of Defence, *Australian Defence Force Recruiting Strategic Plan 2007–17*, 1 July 2007, p. 12.

⁶⁰ In 2008, global financial conditions deteriorated markedly and global financial markets experienced significant turbulence as a result of the failure of major financial institutions and companies in the United States of America and Europe. In late December 2008, the effects of a global recession and economic crisis were being felt in Australia across both the public and private sector. The effect of the global financial crisis on the Prime Contractor's business operation is discussed in Chapter 3.

⁶¹ Department of Defence, *Retention and Recruitment Talking Points*, Ministerial Submission, HPC/OUT/2009/R3810787, 16 March 2009, p. 15.

2.10 Without the addition of Defence personnel at these critical points and the actions of CMG, there was the potential for a further increase in the conversion ratio that would not necessarily have led to an increase in offers or enlistments. CMG was reliant upon Defence's intervention to reduce some of the blockages in the recruitment pipeline that otherwise could have affected its revenue since it received payment for successful conduct of a recruitment at the point a candidate was enlisted.⁶²

Pricing framework for the New DFR Contract

2.11 In January 2007, Defence engaged a consultant to review the pricing of the DFR contract then in place and develop an economic model to support the implementation of a New DFR model. The economic model was based on information supplied by Defence and Manpower about service delivery arrangements, financial information from 2005–06, industry benchmarks and the consultant's own commercial experience.

2.12 The model, and the DFR contract then in place, was used by Defence's Project Advisors for the New DFR procurement to prepare for and undertake the Request For Tender (RFT) financial assessment. With the new contract, Defence sought two outcomes:

- to provide tangible incentives for the achievement of recruiting targets; and
- greater budgetary control for Defence under the new contract.

2.13 The Pricing Schedule under the New DFR Contract with CMG included the capacity for Defence to pay the contractor for the following items: a fixed fee; a per head recruitment fee; an additional per head incentive fee; reimbursable costs; debt financing costs; transitional adjustment payments; and, any applicable Goods and Services Tax.⁶³

2.14 The composition of the Pricing Schedule for the New DFR Contract reflects one of Defence's major aims of the New DFR model—to achieve greater budgetary control under the contract. Defence considered that there

⁶² The majority of the Prime Contractor's revenue under the New DFR Contract is delivered through payments related to achievement of recruitment such that candidates are enlisted (some 63 per cent). However, about a third of its revenue is in the form of a fixed fee to cover ongoing DFR service delivery. See paragraph 2.15.

⁶³ Department of Defence, *New DFR Recruiting Services Contract*, July 2008, Attachment 7 Pricing Schedule, p. 282.

was a risk that the wide range of reimbursable costs that Defence was liable for under the previous DFR contract with Manpower had the potential to increase and were uncapped. Accordingly, in establishing the New DFR Contract, Defence increased the fixed fee payment component of revenue under the contract from six per cent to 35 per cent of the total available amount and made a corresponding reduction to the reimbursable costs from 19 per cent to five per cent.

2.15 The bulk of the payments to CMG under the New DFR Contract comprised the following elements:

- **fixed fee**—paid monthly for ongoing DFR service delivery and subject to annual indexation using the Consumer Price Index published by the Australian Bureau of Statistics;
- **performance-based fee**—paid monthly, comprising a variable, per-head recruitment fee for each verified enlistment depending upon the recruit's employment category (officer, general entry, other). Also includes the additional per head incentive payment, allocated by Defence, for any specific ADF employment category or target number determined by the single Services as being critical and subject to supply pressure (referred to paragraph 2.13); and
- **reimbursable costs**—comprising, for example, costs for the use of Defence owned/leased establishments, maintenance of Government furnished equipment, also includes some temporary costs for candidate travel and some medical specialist appointments.⁶⁴

2.16 The pricing framework for the New DFR Contract was established with the aim of ensuring that CMG had a strong incentive to maximise the achievement of annual recruiting targets.

Performance

2.17 As discussed in Chapter 1 (see paragraph 1.6), Defence sets annual and long-term targets for ADF recruitment. However, these targets had not been met in several decades.⁶⁵ In 2006, the then Government approved significant

⁶⁴ Department of Defence, Ministerial Submission, *Performance of the ADF Recruiting Services Contract – Update*, DEPSECPSP/OUT/2009/104, 8 July 2009, paragraph 11, p. 2.

⁶⁵ Department of Defence, *Australian Defence Force Recruiting Strategic Plan 2007–17*, 1 July 2007, p. 3.

additional funding for Defence for recruitment and retention initiatives (approximately \$3.1 billion) over the next decade in order to increase the size of the full-time military workforce in the ADF to 57 000 personnel by 2016.⁶⁶ The 2009 Defence White Paper increased the target military workforce by approximately 800 full-time ADF personnel to 57 800 by 2019.

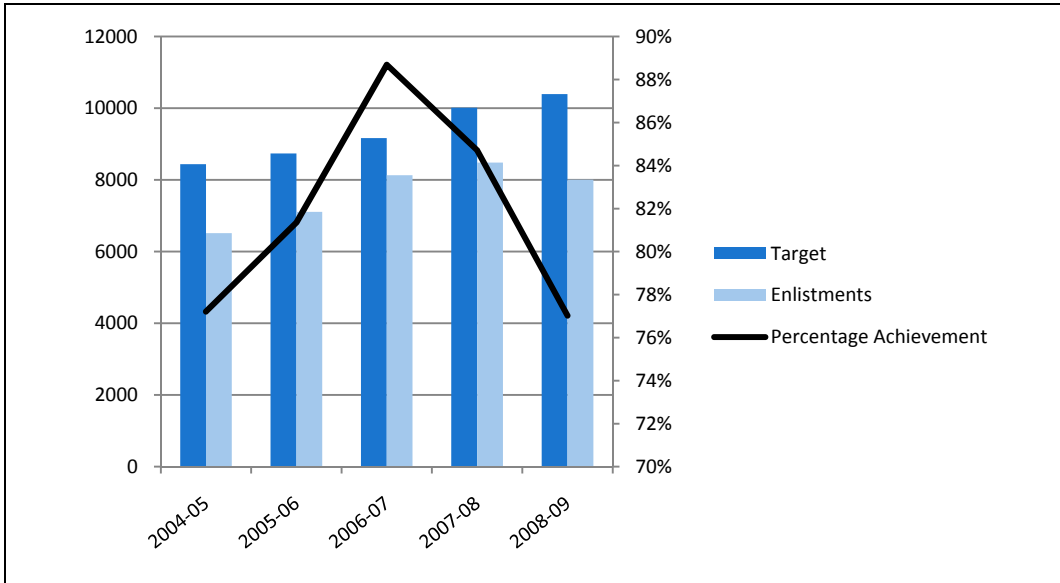
2.18 Figure 2.2 shows the recruitment targets, achievement and percentage achieved by DFR for the five years from 2004–05 to 2008–09.⁶⁷

⁶⁶ The funding was announced in December 2006 and as part of the 2007–08 Federal Budget. Department of Defence, *Annual Report 2006–07*, Defence, Canberra, October 2007, Volume One, p. 124.

⁶⁷ In this circumstance, DFR is Defence and its contractors acting in collaboration as Defence Force Recruiting.

Figure 2.2

Recruitment into the ADF through Defence Force Recruiting (except Gap Year entry): target recruitment, achieved recruitment, and percentage of target achieved from 2004–05 to 2008–09



Notes: (A) The ADF Gap Year offers a 'try before you buy' experience of military training and lifestyle for young men and women, without any obligation to serve beyond the 12 month program. ADF Gap Year participants have the option of voluntarily transferring to full-time or part-time ADF careers or training. There is also an incentive bonus for participants who complete the Gap Year, complete a recognised tertiary or vocational qualification and re-join the ADF within five years.

(B) Defence informed the ANAO that these figures are sourced from internal DFR data which informs ADF workforce planning data. Workforce planning data is the official data utilised to measure ADF recruitment achievement. This data may not align with released ADF workforce planning figures but has been used here because it is the data used for assessing performance of the DFR contractor. Defence informed the ANAO that, with the inclusion of Gap Year entry, recruiting targets in 2008–09 did not fall below 11 000 (thus staying above the 10 500 set down in the RFT standard scenario).

Source: Department of Defence, Operational Management Group and Board of Management Reporting Tool, August 2009, p. 39.

2.19 The time period represented in Figure 2.2 covers much of the period since the commencement of an outsourced, collaborative DFR model (the first contract with Manpower being delivered from July 2003) until the end of the 2008–09 financial year. During the period covered by Figure 2.2, the lowest level of recruitment achievement was 77 per cent (2004–05) and the highest level 89 per cent (2006–07).

2.20 In December 2006, Defence proposed reforms to DFR to reduce the length of the recruitment process from enquiry to enlistment and improve the conversion ratio, with the aim of allowing Defence to meet its recruitment

targets. As noted in paragraph 1.13, Defence commenced the introduction of the New DFR model with Manpower during 2007–08. Table 2.1 shows DFR performance against a number of effectiveness and cost/efficiency targets that Defence proposed to Government to measure the success of the new recruitment model.

Table 2.1

DFR recruitment targets and actual achievement 2007–08 to 2009–10

Description	Target					
Effectiveness measure	2007–08 Target Actual ^A		2008–09 Target Actual ^B		2009–10 Target Actual ^C	
Increasing the percentage of overall full-time enlistment targets achieved from 84 per cent, in December 2006	86 per cent	81.6 per cent	88 per cent	78.9 per cent	90 per cent	90.9 per cent
Improving the conversion ratio (enquiry to application to enlistment) from 13:3:1, in December 2006	12:3:1	12:3:1	11:3:1	12:3:1	11:3:1	12.9:2.5:1
Cost/efficiency measure						
Maintaining the cost per recruit at \$0.013 million, the same level as in December 2006	\$0.013 million	\$0.017 million	\$0.013 million	\$0.018 million	\$0.013 million	\$0.013 million
Reducing the time taken to process applications for general enlistment to the ADF from an average of 30 weeks, in December 2006 ^D	15 weeks	34 weeks	10 weeks	41 weeks	6 weeks ^E	49 weeks

Notes: (A) Manpower contributed to the actual performance achieved during 2007–08.

(B) Manpower contributed to the actual performance achieved from 1 July 2008 to 31 January 2009. CMG commenced delivery of the New DFR Contract on 1 February 2009; continuing to 30 June 2009.

(C) The Actual results for 2009–10 are for the first six months of the year. CMG contributed to the actual performance achieved from 1 July 2009 to 31 December 2009. The New DFR Contract ended at the end of January 2010 and Defence put in place alternative contract arrangements with Manpower for the remainder of 2009–10 and until March 2012.

(D) This efficiency measure relates to the total time taken from enquiry to enlistment. The period referred to in paragraph 2.6, initial interview (YOU session) to the issue of a letter of offer, relates to a segment within the complete period between enquiry and enlistment.

(E) Defence informed the ANAO that: ‘the 6 week target referred to was developed in 2006 when the environmental context was very different, and is based on an industry benchmark for time in process. Defence has dropped this industry benchmark target as unsuitable for ADF recruitment and it will not appear in the next ADF Recruiting Strategic Plan which is currently being developed.’

Source: Department of Defence and ANAO analysis.

2.21 Table 2.1 shows that performance of DFR since July 2008 has been mixed. In February 2010, Defence informed the ANAO that the efficiency improvements identified in the targets in Table 2.1 have yet to be realised, largely as they are associated with operating model optimisation which was one of the objectives of the New DFR Contract. The target recruitment level for the first six months of 2009–10 (4212) is seven per cent less than the target was for the comparable period in 2008–09 (4530). Nevertheless, the actual number of enlistments achieved in the first six months of 2009–10 was 486 higher than the actual number of enlistments achieved in the comparable period in 2008–09. The overall target for 2009–10 is 9280, which is 11.6 per cent less than the target number used in the tender assessment process for the New DFR Contract (10 500). The achievement of 90.9 per cent of the recruitment target in the first six months of 2009–10 is derived from a calculation using lower targets set by Defence compared with the previous year (some seven per cent lower) and an increase in the total number of people recruited. Defence informed the ANAO that enquiries, applications and actual numbers of enlistments all grew significantly over the last six months of 2009 compared to the similar period in 2008.

2.22 For the first six months of the 2009–10 year, the average time taken to process applications for general enlistment was high at 49 weeks, some eight times the current target. Defence informed the ANAO that this period reflects the average time between enquiry and enlistment for General Entry applicants. Defence stated that the period covered by this measure does not represent the recruiting time only as there can be delays between an enquiry and an application (where the candidate does not immediately follow through with their application), and delays until the next available training intake. Defence also indicated that during the difficult economic period in 2008 and 2009 there was a higher than usual number of enquiries and applications that were not genuine.

2.23 The average time involved between enquiry and enlistment for applicants to General Entry is now more than 60 per cent higher than it was in December 2006. However, Defence advised that:

a more accurate measure of recruiting time in process is the time between a candidate attending a YOU (Your Opportunities Unlimited) Session, and being issued with a Letter of Offer. This represents the period in which recruitment

processing activity occurs. The median⁶⁸ time between YOU and Letter of Offer was 19 weeks in 2006. This has extended to 23 weeks by 2010, representing a 21 per cent increase in recruitment processing times, despite DFR reforms and increased funding to support a more streamlined recruitment process.

Although recruitment processing times have increased since 2006, recruiting target achievement has increased significantly, whilst the average cost per recruit has been maintained at 2006 levels. This suggests that the existing time-in-process efficiency measure may need to be reviewed in terms of its utility as a measure of overall recruiting efficiency. Nevertheless, the efficiency gains in recruitment processing expected under the New DFR service delivery model have yet to be fully realised and this is a matter Defence should take action to address.⁶⁹

Recommendation No.1

2.24 The ANAO recommends that Defence implements necessary improvements in the efficiency of recruitment processes, including candidate processing times from receipt of an application to issuing a Letter of Offer, to the extent such actions deliver cost-effective improvements in overall recruiting outcomes.

Defence response

2.25 *Agreed.*

2.26 The New DFR Contract with CMG for the provision of services to the ADF stated at the beginning of the Formal Agreement that:

Defence requires the New DFR Contract Services to be performed by the Contractor in accordance with this Contract, in consideration of which the Contractor will be paid fees in accordance with Attachment 7 (including Reimbursable Costs and GST).

Defence and the Contractor promise to perform their respective obligations under the Contract.⁷⁰

⁶⁸ The relevant efficiency measure Defence proposed to Government in 2006 refers to the 'average' time, or mean, and, accordingly, is a different measure to the 'median' time data provided by Defence in paragraph 2.23.

⁶⁹ Defence advice to the ANAO dated 31 May 2010.

⁷⁰ Department of Defence, *New DFR Recruiting Services Contract*, July 2008, Recital A and Operative 1, p. 8.

2.27 The obligations of the respective parties are detailed in the New DFR Contract's Statement of Work (SOW), to which is attached a Performance Management Schedule. The schedule contained a total of 22 key performance indicators (KPIs) specified as being either 'Important' or 'Critical' in respect of the New DFR Contract services.⁷¹

2.28 The schedule contained two 'Important' KPIs for ab initio and prior service recruitment performance. The performance standard for both types of recruitment was specified at 100 per cent achievement against vacancies.⁷² The schedule also specified that CMG was responsible for providing the data for reporting against both KPIs.

2.29 As previously discussed (see paragraph 2.4), DFR provides integrated recruitment services for the ADF under a customer/supplier arrangement supported by a formal contract containing a SOW that details the parties' respective obligations. As such, the achievement of recruitment performance against ADF targets is a shared outcome not one which is the sole responsibility of the prime contractor.⁷³ Defence has a significant interest in its ADF recruitment targets being met, and accordingly would be expected to take actions, where its resources permit, to facilitate the smooth processing of potential recruits and the achievement of targets. The KPIs for ab initio and prior service recruitment targets in the New DFR Contract, together with the contractor's remuneration being partially dependent on achievement, served to make sure that it was also in the contractor's interest to meet Defence's recruitment targets. The ANAO considers that the Performance Management Schedule under future contracts should be reviewed to better reflect this aspect of the collaboration.

2.30 The ANAO also considers that there was some ambiguity in the New DFR Contract with CMG concerning the KPIs. For example, the contract stated that:

⁷¹ Department of Defence, *New DFR Recruiting Services Contract*, July 2008, Annexure A – Performance Management Schedule, pp. 231–233.

⁷² The termination deed signed by Defence and CMG in October 2009 (and amended in December 2009) included the same KPI until the completion of the transition out of CMG, but reduced to 85 per cent achievement against vacancies in the case of ab initio enlistments.

⁷³ As described in Chapter 1, Defence determines the annual ADF recruitment targets, defines the entry standards to the ADF and makes the final selection for ADF enlistment with the contractor's support.

Subject to the terms of this Contract, Defence engages the Contractor to perform the New DFR Contract Services, so as to:

- (i) Meet all KPIs, Important KPIs and Critical KPIs.⁷⁴

2.31 The ANAO agrees that, as a general principle, it is important to ensure that contracts such as the New DFR Contract make contractors responsible for delivering contracted services to the required standard and that requiring them to meet specified KPIs is a useful way to do this. However, the successful achievement of some of the KPIs set out in the New DFR Contract required the prime contractor and Defence to work collaboratively in order to achieve the required outcome, with each party reliant to some extent on the other if they were to be in a position to successfully complete their own responsibilities. For example, given the design of the New DFR model, the prime contractor could not by itself achieve the KPI related to the recruitment targets as Defence was responsible for carrying out a number of key activities, including making key decisions, during the recruitment process. Where this is the case, the recruiting services arrangements would benefit from the shared responsibility for achieving KPIs being reflected in the contract and the contractor held accountable for those aspects of performance that it is able to control.

2.32 On the other hand, for KPIs where the prime contractor has sole control over, as well as sole responsibility for, the delivery of services, such as IT systems availability, it is clearly appropriate to make the prime contractor solely responsible for meeting the related KPI.

2.33 Given Defence's experience with the New DFR Contract, there is an opportunity for Defence to develop a new performance measurement framework for inclusion in any future DFR service delivery contracts that recognises that achieving certain KPIs is a collaborative effort, involving both Defence and the contractor.

Future options for the DFR model

2.34 As discussed in Chapter 1 (paragraph 1.14), Defence and CMG formally agreed a process in October 2009 that would lead to the termination of the New DFR Contract at the end of January 2010—one year after CMG assumed responsibility for delivering DFR services. In December 2009, Defence entered

⁷⁴ Department of Defence, *New DFR Recruiting Services Contract*, July 2008, Contracted Requirement, p. 11.

an interim contract with Manpower to provide recruitment services for two years from 1 February 2010.

2.35 Defence informed the ANAO in late 2009 that the agency was undertaking an assessment of the options available for the future delivery of DFR following the interim contract, including continuing with an outsourced model or returning the function to solely Defence delivered.

2.36 An issue that Defence could usefully address in the context of this review relates to the pricing model that the department would include in any future DFR contract. By the time Defence was seeking to put in place an interim provider for DFR in late 2009, the department had identified a significant issue related to the pricing model that had been included in the New DFR Contract. Under the New DFR Contract, the bulk of the payments to CMG were comprised of a: fixed fee; performance-based fee; and reimbursable costs (see paragraphs 2.11–2.16). The New DFR Contract’s pricing model used a fee structure whereby Defence paid CMG base, per head, achievement and incentive payments to offset the additional costs likely to be incurred by CMG in targeting and processing ‘hard to get’ categories of recruits and categories determined by Defence annually as being a priority.⁷⁵ CMG’s payment related to recruitment achievement was paid based upon enlistment numbers being verified by Defence. The pricing proposals submitted by tenderers for the New DFR Contract were based on a target recruitment level of 10 500 per annum over the five year life of the contract. Defence advised that: ‘This figure was chosen to provide a common and realistic basis for assessing tender pricing and was not a commitment to tenderers of any future target level.’⁷⁶

2.37 Tenderers were not asked to consider pricing under alternative recruitment target levels, although many of the costs are fixed under the New DFR Contract which limited a contractor’s ability to adjust costs in response to lower recruitment target levels. This approach meant that the successful tenderer may well be disadvantaged (and incur losses) if Defence were to

⁷⁵ Under the *New DFR Recruiting Services Contract*, base, per head, recruitment fees range from \$2800–\$7500 per category of candidate and from \$500–\$10 000 for the additional per head incentive payment. Department of Defence, *New DFR Recruiting Services Contract*, July 2008, pp. 288–289.

⁷⁶ Defence advice to the ANAO dated 31 May 2010.

reduce target recruitment levels without adjusting pricing.⁷⁷ As it transpired, by the time that Defence was in the process of engaging an interim provider for DFR in late 2009, retention levels in the ADF had risen and Defence was reducing its targets for ADF recruitment.

2.38 Movements in the targets for recruitment can occur because of increased retention by the ADF, as well as changes to government policy or budgetary constraints. In recognition of the likely impacts on any contractor from falling recruitment targets, the Interim Contract with Manpower for recruitment services from 1 February 2010 includes a provision for two different sets of prices to apply for the fixed fee and the performance fee, depending on whether Defence's annual recruitment target is under or over 9 500 per annum. This contrasts with the New DFR Contract which did not include any pricing flexibility related to recruitment volumes. Indeed, as discussed in paragraph 2.36, tenderers for the New DFR Contract were required to submit prices based on the tenderers fully achieving a Defence recruitment target of 10 500 per annum.

2.39 It could prove difficult for commercial firms to provide a single rate for their services when they do not have reasonable certainty about the potential quantity of services for which they are to be paid (because of Defence changes to recruitment targets). If, following the review foreshadowed in paragraph 2.35, Defence does decide to approach the market again to obtain a prime contractor to deliver DFR services under a collaborative model, then there would be an opportunity to review, among other things, the pricing model supporting the DFR services contract to be used in any longer term contract.

2.40 If Defence wishes to retain the right to vary the target levels of recruitment from year to year, or more frequently as required, the ANAO suggests that there may be merit in seeking from tenderers a proposal for a sliding scale for per head recruitment fees based on recruitment levels being set within different ranges (for example, 7000 to 8000, 8000 to 9000, 9000 to 10 000 and 10 000 to 11 000). This would allow for any new contract to include different pricing depending on the level of recruiting required, which should provide Defence with the opportunity to capture the benefits of economies of

⁷⁷ The Interim Contract for Recruitment Services with Manpower, signed in December 2009 with services commencing 1 February 2010, provides for a Banded Pricing arrangement for both the Fixed Fee and Per Head Recruitment Fee. Band 1 pricing is to apply where annual recruitment vacancies were are equal to or less than 9500, and Band 2 pricing is to apply where annual vacancies are greater than 9500 (see paragraph 5.63).

scale while at the same time not risking either tenderers including a risk premium in their pricing proposals because all of the risk associated with reduction of recruiting targets rests with the contractor, or putting tenderers' financial viability in jeopardy if recruiting targets are revised downwards sharply.

2.41 Similar approaches are already being used in Defence (such as that in place to deliver a range of garrison support services), that might be useful for Defence to consider in this context.⁷⁸ For example, garrison support services contracts include different prices for different volumes of certain services.

Provision for innovation

2.42 For the purposes of the tender pricing under the Request for Tender for the New DFR Contract, tenderers were provided with a spreadsheet-based template for costing and pricing purposes. This spreadsheet contained detailed information including the existence of 16 DFRCs and the numbers of staff required to be provided. The template also required pricing information to be provided against a standard scenario using an annual recruiting target of 10 500 per year.

2.43 Given the relatively prescriptive nature of the approach to the New DFR Contract, there is scope for Defence to consider whether it could achieve efficiencies through the introduction of 'gain share' arrangements under any future long term contract for DFR.⁷⁹ Achieving longer term efficiencies in the DFR processes could be assisted by the introduction of innovation in the delivery of DFR services. For example, the use of alternative methods of delivering services in certain locations may result in a reduction in costs associated with staffing and property operating costs. Alternatively, there may be scope to revise particular aspects of the New DFR model itself by introducing innovations that have been shown to increase efficiency at a particular DFR location, or in recruitment activity undertaken for other clients of the prime contractor.

⁷⁸ The ANAO reported on the delivery of garrison support services in ANAO Audit Report No.11 2009–10 *Garrison Support Services*.

⁷⁹ Gain share refers to a mechanism in a contract that would promote initiatives by contractors to make savings in the cost of the contract, with the benefit of the saving being shared by the organisation receiving the service and the service provider.

2.44 Defence informed the ANAO that the New DFR provides for the contractor to improve upon the performance of its obligations across a very broad range of service delivery and business processes under specific continuous improvement provisions. Defence is satisfied that these contractual requirements provide a sound basis for innovation where efficiencies are reinvested in the recruiting enterprise, without the more complex management of a gain share arrangement that uses cost savings as a driver for improved efficiency.

2.45 However, the ANAO suggests there is scope with future contracts for Defence to build on existing continuous improvement provisions and include a form of sliding scale for pricing in any longer term recruitment contracts as it has in the Interim Contract with Manpower.

3. New DFR Contract Procurement

This chapter examines the Department of Defence's management of the tender process for the New DFR Contract for recruiting services under which CMG took over responsibility for the delivery of recruitment services for the ADF on 1 February 2009.

Introduction

3.1 In September 2007, Defence issued an open invitation to the Australian market for companies to register their interest in providing a range of services to support the recruitment of personnel to the ADF. Defence was seeking a private sector, external service provider to deliver DFR services to the ADF into the future.

3.2 The tender process for the New DFR recruiting services contract (New DFR Contract) was conducted by Defence as a complex procurement.⁸⁰ Defence's rationale for determining that the procurement was complex was the: procurement's high public profile; complex nature of services to be provided; procurement's importance to future ADF capability; and level of investment involved in the contract.⁸¹

3.3 Following an overview of the tender process, the rest of this chapter's structure aligns with the three major stages described in the *Defence Procurement Policy Manual* (DPPM) for a complex procurement for services:

- preparation for procurement;
- evaluation of tenders; and
- contractual negotiation.⁸²

⁸⁰ The *Defence Procurement Policy Manual* (DPPM) is maintained by the Defence Material Organisation and is the primary reference document for all Defence procurement. The DPPM defines complex procurement as being: 'carried out under limited guidance within a broad framework of policy and best practice. The nature of the requirement is usually more complex and the method of procurement will likely involve the development and issue of formal request documentation. Department of Defence, *Defence Procurement Policy Manual*, Version 6.0, Defence, Canberra, 2006, p. 1.3.5.

⁸¹ Department of Defence, *DFR Procurement Plan*, September 2007, p. 20.

⁸² The ANAO's chapter structure is based on analysis of the 'Department of Defence Complex Procurement Process' diagram in Department of Defence, *Defence Procurement Policy Manual*, Version 6.0, Defence, Canberra, 2006, p. 24.

3.4 The ANAO's analysis focused on Defence's management of the tender process from the perspective of the agency's compliance with the requirements for procurement contained in the following legislation and guidelines:

- *Financial Management and Accountability Act 1997* and the associated regulations;⁸³
- *Commonwealth Procurement Guidelines* (CPGs), January 2005;⁸⁴
- *Defence Procurement Policy Manual*;⁸⁵ and
- Defence's *Chief Executive Instructions*.⁸⁶

Overview of the tender process

3.5 In December 2006, the then Minister for Defence agreed to a staged procurement for the New DFR Contract, involving an open (public) invitation to register interest (ITR) and subsequent provision of a restricted request for tender (RFT) to shortlisted service providers who responded to the ITR. The procurement's objective was to select the most suitable contractor/s to deliver services under the New DFR model and provide the best value for money to the Commonwealth.⁸⁷

3.6 Defence originally intended that the New DFR Contract would commence in April 2008. Defence subsequently decided to extend the recruiting services contract then in place with Manpower and revised the timeframe to complete the New DFR procurement. As a consequence, the New DFR Contract was signed in July 2008 with the new prime contractor, CMG, undertaking to commence full service delivery in February 2009 after a seven month transition period between contractors.

3.7 The Defence decision-maker, who took the decision in November 2007 to extend the previous DFR contract and the timeframe of the New DFR

⁸³ *Financial Management and Accountability Regulations 1997*.

⁸⁴ The current version of the CPGs available to Defence's officials and advisors at the time of the New DFR contract's tender process.

⁸⁵ DPPM, Version 6.0, 2006 was the current version of the DPPM available to Defence's officials and advisors at the time of the New DFR contract's tender process. Version 6.0 advice was supplemented by advice contained in Update 6.1 and Update 6.2.

⁸⁶ Defence's *Chief Executive Instructions* set out both policy and operational guidelines that all Defence officials are required to comply with.

⁸⁷ Department of Defence, *DFR Procurement Plan*, September 2007, p. 12.

procurement, was advised that this was necessary because key elements of the trial of the New DFR service delivery model—the case management of candidates and Information Technology (IT) systems—were not then fully operational or tested. Defence had originally intended to use the results of the trial, which began in July 2007, to inform the procurement process.⁸⁸ However, in the event, the trial and the procurement proceeded concurrently in 2007–08.

3.8 Table 3.1 presents an overview of the tender process that took place from September 2007–July 2008.

Table 3.1

Tender process for the New DFR Contract 2007–08

Date	Activity	Additional detail
14 September 2007	Invitation to Register (ITR) Interest opened.	AusTender, ^A NewDFR2/07, open process.
19 October 2007	ITR closed.	Defence received 11 responses of which it shortlisted seven companies to proceed further.
7 February 2008	Request for Tender (RFT) released	NewDFR3/08, restricted process, seven companies invited to submit responses to the RFT.
4 April 2008	RFT closed.	Defence received three compliant tender responses (CMG, Manpower and a third tenderer) based on a prime/sub-contractor model and one further potential consortium withdrew for commercial reasons.
17 April 2008	Amended RFT released.	Following removal by Defence of the Job Options Service (formerly the Employment Advice and Transition Service) from the tender request.
1 May 2008	Amended RFT closed.	All three tenderers submitted responses to the amended RFT.
26 May 2008	Preferred tenderer determined by Defence.	Defence identified a preferred tenderer (not announced publicly), a second shortlisted tenderer and an unsuccessful tenderer.

⁸⁸ Department of Defence, Minute to Head Personnel Executive, DGDFR/2007/OUT/429, *Extension of the Contract for Provision of Recruiting Services to the ADF*, 5 November 2007.

Date	Activity	Additional detail
27 May 2008	Tenderers advised of the RFT outcome.	
28 May–1 July 2008	Contractual negotiation period.	Negotiations conducted with only CMG as the preferred tenderer.
2 July 2008	Contract signature.	Contract covered a seven month transition period between contractors followed by a five year term from 1 February 2009–1 February 2014.
July 2008	Tenderer debriefing sessions.	Attended by Manpower and the third tenderer.

Notes: (A) The AusTender website is the Australian Government's procurement information system. AusTender provides centralised publication of Australian Government business opportunities, annual procurement plans, multi-use lists and contracts awarded. The website is available from <<https://www.tenders.gov.au>>.

Source: ANAO analysis, 2010.

Scope

3.9 The ITR advised that the scope of the project was to deliver the existing marketing and recruiting services for DFR and a new employment advice and transition service (EATS), which was renamed as the Job Options Services (JOS) during the RFT process.⁸⁹ Figure 3.1 sets out the description of the three work packages contained in the ITR.

⁸⁹ Tenderers were advised that many of the research and production activities in support of DFR marketing functions are delivered through other existing contracts managed by Defence. Department of Defence, *Request for Tender, Part 2 - Information Provided to Requestors*, paragraph 5.6.4, p. 16.

Figure 3.1**Description of the three work packages contained in the ITR**

- *Marketing services:*

The primary objective of New DFR marketing services is to develop, manage and deliver marketing and branding solutions for the ADF to attract sufficient numbers of enquiries to enable DFR to fill its allocated recruiting vacancies and generate broader interest in the ADF. The supplier of marketing services will be responsible for the management of ADF recruitment marketing and Service branding to generate sufficient enquiries each year to fill allocated recruiting vacancies, including but not limited to specified management, marketing and Internet functions.

The ITR also specified marketing services-related functions likely to be retained by Defence and functions likely to be provided by other organisations. Many of the research and production activities in support of DFR marketing functions are delivered through existing contracts managed by Defence.

- *Recruiting services:*

The primary objective of the New DFR recruiting services is to manage prospective candidates through a recruitment process (from 'Enquiry to Enlistment') to enable DFR to fill its allocated recruitment vacancies. In accordance with Service policies and New DFR processes, the provider will be responsible for delivering recruiting services Australia-wide to fill allocated ADF recruitment vacancies.

This will include, but not be limited to, specified management, candidate relationship management, DFRC and IT functions. The ITR also specified recruiting services-related functions likely to be retained by Defence and functions likely to be provided by other organisations.

- *Employment advice and transition service (EATS) - which was later renamed Job Options Services (JOS):*

The primary objective of the EATS is to enhance the retention of permanent ADF members considering discharge, encourage the recruitment of members with prior experience and ensure that those members of the ADF who do separate value their ADF experience and smoothly transition into civilian employment. EATS will require the service provider to be responsible for ensuring that ADF members are well informed and consider the full range of career opportunities available within the ADF—as well as those outside—when considering their future career options. For those who do decide to separate from the ADF, the service provider is responsible for ensuring that they value their ADF career and are prepared for transition to civilian employment and finally are well placed to return to Service in the ADF in either their prior or alternate capacity.

This will include but not be limited to, specified management, employment advice and transition functions. The ITR also specified EATS-related functions likely to be retained by Defence and functions likely to be provided by other organisations.

Source: Department of Defence, *ITR No. NewDFR2/07, Invitation to Register Interest, Part 2 – Information Provided to Requestors*, pp. 26–36.

3.10 After a review of the Defence budget in May 2008, Defence decided to reduce the RFT's scope by removing the JOS component.⁹⁰ While Defence had already begun assessing the tender responses on 10 April 2008, the *New DFR Recruiting Services Contract RFT Preliminary Source Evaluation Report*, May 2008, stated that the tender evaluation team did not assess the JOS component of any of the tenderers' responses or change the original weighting of criteria following the removal of the JOS.

Preparation for procurement

3.11 Defence engaged a range of advisors to assist in the conduct of the procurement. The advisors for the project were:

- KPMG (referred to as the Project Advisor in this report). Defence engaged the Project Advisor to provide expert acquisition and contracting services in support of the development of suitable procurement and contracting documents for Defence to use for the New DFR procurement. The advice was required to encompass the requirements of the DPPM and the CPGs. The Project Advisor also performed the Internal Probity Officer's role that focussed on identifying and managing probity issues arising from the existing relationship between Defence and the Manpower.
- Deloitte Touche Tohmatsu (referred to as the External Probity Advisor in this report) was engaged by Defence to provide probity advice for key activities during the New DFR procurement, as well as ensuring compliance with the probity plan.
- Clayton Utz (referred to as the Legal Advisor in this report) provided legal advice to Defence throughout the tender process.

3.12 Defence informed the ANAO that it paid KPMG \$674 307 for tender development and advice, and paid \$24 933 to Deloitte Touche Tohmatsu for probity advice. Defence informed the ANAO that it also paid \$1.05 million to Clayton Utz during the procurement stage which included contract advice between August 2007 and August 2008, advice during the negotiation phase of the procurement, and the cost of advice during transition from Manpower to CMG. Defence also indicated that two of its staff were substantially dedicated

⁹⁰ Department of Defence, Ministerial Submission DEPSEC PSP/OUT/2008/64, *ADF Recruiting Services Contract Scope Reduction*, 17 April 2008.

to procurement activity related to the New DFR for a combined period of approximately two years.

Development of major procurement planning documents

3.13 The ANAO analysed Defence's tender process for the New DFR Contract in terms of its consistency with the requirements contained in the DPPM for the production of major procurement planning documents. For example, the development of procurement, probity, risk management and tender evaluation plans and the completion of ITR and RFT evaluation reports.

3.14 Defence produced a comprehensive set of procurement planning documents for the New DFR tender process that were consistent with the requirements contained in the DPPM. The major procurement planning documents were also consistent with the requirements of Finance's *Guidance on the Mandatory Procurement Procedures*.⁹¹

Recordkeeping arrangements

3.15 Defence maintained a record of the final approved version of tender process documents using a combination of agency registry files and electronic records. Overall, the ANAO considers that the records maintained by Defence represented a sound audit trail that covered the key activities undertaken during the tender process, albeit that records for some aspects of the management of probity matters were incomplete (see the following section).

Probity management

3.16 Irrespective of a procurement's monetary value, the practical application of probity principles is essential to ensure the integrity of the process and the final outcome.⁹²

3.17 In terms of specific probity risks for the New DFR tender process, the *New DFR Recruiting Services Contract Probity Plan* (the probity plan) noted:

The long duration and close working relationship between the current service provider [Manpower] and Defence results in a number of acquisition related

⁹¹ Department of Finance and Administration, *Guidance on the Mandatory Procurement Procedures* Financial Management Guidance No. 13, Finance, Canberra, 2005. The publication is available from <<http://www.finance.gov.au>> [accessed 15 June 2009].

⁹² Australian National Audit Office, *Better Practice Guide—Fairness and Transparency in Purchasing Decisions*, August 2007, ANAO, Canberra, p. 15.

probity risks specific to the DFR Project which are in addition to those probity risks usually associated with an acquisition of this nature.⁹³

3.18 The probity plan required the secure storage of forms signed by key personnel involved in the tender process that acknowledged the associated probity obligations. Defence informed the ANAO that probity acknowledgement forms were signed by everyone who accessed the procurement documents. However, Defence's files do not contain a full record of the forms or a checklist, or similar document, that Defence used at the time to ensure the probity requirements were met.⁹⁴

3.19 The External Probity Advisor's December 2007 and May 2008 reports record sighting of the probity acknowledgement and conflict of interest forms and raised no concerns from a probity perspective with their handling. In total, the External Probity Advisor provided four favourable reports on the conduct of the tender process from September 2007 to May 2008. The External Probity Advisor was subsequently re-engaged in March 2009 to retrospectively review the contractual negotiation process and provided a similar level of assurance in its final report.

3.20 The records reviewed by the ANAO show that Defence gave a high priority to the probity arrangements and endeavoured to rigorously implement the probity plan. As far as the ANAO can establish from the existing records, probity was managed appropriately by Defence during the New DFR procurement.

Data and information used as part of the tender process

3.21 Before starting a procurement for service delivery, particularly for service delivery that is already outsourced, sound practice is for agencies to undertake a review to establish the specifications of the services to be required under the new contract and obtain the necessary data about how the relevant activities are currently being delivered as a fundamental part of their preparation before approaching the market. A key element of such a review is

⁹³ Department of Defence, *New DFR Recruiting Services Contract Probity Plan*, September 2007, p. 6.

⁹⁴ Defence informed the ANAO that the Project Advisor stored the probity acknowledgement records externally during the procurement process. However, the ANAO notes that, aside from any interim arrangements that were in place, Defence was ultimately responsible for the appropriate storage and maintenance of Commonwealth records.

to verify the accuracy and completeness of the information to be provided to tenderers to underpin their tender proposals.⁹⁵

3.22 Defence was made aware of the advisability of preparing for the tender process by its Legal Advisor in October 2007, after the ITR was released in September 2007. The legal advice explicitly discussed the IT systems, leases for establishments, and their novation, the novation of subcontracts, Government furnished equipment (GFE), and other furniture, fittings and equipment requirements for the contract then in place and clearly suggested to Defence the need for a stocktake as soon as practicable.⁹⁶

3.23 In preparing for the tender, Defence relied extensively on advice and information from the incumbent prime contractor, Manpower. The type of information sought included details of the vehicles used in performing recruiting functions, the GFE,⁹⁷ subcontractors and IT systems.⁹⁸ Defence also consulted widely with other stakeholders in Defence, including the single Services. However, Defence's efforts in preparing for the tender process were not, in the event, sufficient to ensure that it was in a position to provide complete and accurate advice to tenderers on all aspects of the issues outlined in the October legal advice.

Insufficient preparation

3.24 In addition, an important element of effective contracting for services is the preparation of a proposed Statement of Work (SOW), which is provided to the tenderers during the tender process, that specifies the contract deliverables and is:

⁹⁵ For some activities, this may only require updating information collected as part of an annual audit regime.

⁹⁶ Correspondence from the Legal Adviser to Defence, dated 31 October 2007.

⁹⁷ The New DFR contract defined GFE as follows: 'Government Furnished Equipment' (GFE) means those items of equipment to be made available by Defence (at its absolute discretion) to the contractor, to assist in the performance of the New DFR Contract Services.' Department of Defence, *New DFR Recruiting Services Contract*, July 2008, p. 92.

Examples of GFE for DFR included: medical testing equipment; psychology assessment equipment; tables and chairs; water coolers; televisions and videos; kitchen appliances (refrigerators and microwaves); and compactuses.

⁹⁸ Defence requested from the Previous Contractor a list of the IT systems used to provide recruiting services (including system details, support arrangements and ownership of the systems) and details of the need to novate any third party arrangements. The 'IT systems' were defined as: 'the hardware, software, network infrastructure and voice communications and all system documentation needed to maintain and support the system and its components'. Department of Defence, *Transition Project Charter for the DFR Transition Phase*, 23 September 2008, p. 6.

- as concise as possible, while at the same time fully describing the requirement;
- clear, consistent, unambiguous and does not conflict with itself or other contract terms and conditions;
- complete, accurate and correct;
- feasible and achievable; and
- measurable and verifiable.⁹⁹

3.25 A risk log prepared by the Project Advisor did not identify as a risk for the tender process that Defence would be unable to accurately describe the operation of DFR and specify all of the services to be provided by an external service provider under the proposed New DFR Contract.

3.26 However, the risk log did record a supply-type risk of: 'Failure or poor performance of IT systems due to requirements and system information not fully understood or inappropriate resourcing'.¹⁰⁰ The risk was described as being 'major' with the likelihood of occurrence being 'possible'.¹⁰¹ The suggested mitigation treatment was to transfer the risk in the future to the New DFR Contract's Prime Contractor.

3.27 In later considerations about the commercial difficulties that arose with CMG, Defence acknowledged that it had imperfect knowledge of the operation of DFR under the contract with Manpower in place at the time the tender process was undertaken such that:

Whilst the Request for Tender documentation was explicit regarding the Tenderers' responsibility to inform themselves and not rely on the accuracy, currency or completeness of documentation, Defence was aware that it did not have all reasonably expected information available in certain areas to provide to the Tenderer.¹⁰²

⁹⁹ Australian National Audit Office and Department of Finance and Administration, *Better Practice Guide—Developing and Managing Contracts*, February 2007, ANAO, Canberra, p. 27.

¹⁰⁰ Department of Defence, *DFR Project Risk Log*, version 2.0, 17 October 2007, Risk Log, Item 35.

¹⁰¹ Defence defined 'major' as: 'the contractor provides services that are partly fit for their intended purpose' and 'possible' as: 'the event might occur at some time'. Department of Defence, *DFR Project Risk Log*, version 2.0, 17 October 2007.

¹⁰² Department of Defence, Minute DGDFR/OUT/2009/35, *DFR Response to CMG Submission Without Prejudice*, 19 February 2009, p. 3.

3.28 The major areas of weakness referred to in paragraph 3.27 were information about leases for DFR premises, the operation of IT systems and GFE matters. The importance of this information to the success of the transition period between contractors and in the operation of the New DFR Contract in 2009 is discussed in Chapters 4 and 5.

Clarification questions

3.29 The CPGs advise that:

Agencies need to promptly provide, on request, to any potential supplier participating in a procurement, documentation that includes all information necessary to permit potential suppliers to prepare and lodge responsive submissions to any approach to the market.¹⁰³

3.30 As stated in paragraph 3.27, the conditions for tenderers' participation in the RFT specified that the tender information provided was not necessarily accurate, current or complete.¹⁰⁴ Therefore, the respondents were responsible for making reasonable inquiries and satisfying themselves as to the reliability of the information on which their tenders were based. Table 3.2 presents an example of Defence's response to a clarification question asked by one of the tenderers during the RFT about the IT systems that illustrates the approach taken when Defence found it did not have the necessary data to respond comprehensively.

¹⁰³ Department of Finance and Administration, *Commonwealth Procurement Guidelines*, Financial Management Guidance No.1, DOFA, Canberra, January 2005, p. 21.

¹⁰⁴ Department of Defence, RFT No. New DFR 3/08, *Request for Tender, Part 1 – RFT Conditions*, p. 15.

Table 3.2**New DFR3/08 response to tenderers' clarification question**

No.	RFT Reference	Tenderers' question	Defence's response	Response Date
66	Statement of Work—Section K, Information Technology	Request confirmation that the tender pack addendum to section 9, existing contractor contracts, is a complete and definitive list of what will need to be managed by the Tenderer for the duration of the New DFR agreement.	<p>The list of contracts currently in place is provided as an indicative range of contract type and cost of current operations.</p> <p>Tenderers should make all reasonable enquiries to ensure they consider the cost implication of all contracts they may believe would be required throughout the duration of the contract.</p>	19 March 2008

Source: Department of Defence, *Clarifications from Tenderers #6*, 2 April 2008, p. 21.

3.31 Notwithstanding the approach taken by Defence to address insufficient preparation for the tender process, in early 2009 shortly after it took over the delivery of recruitment services, CMG made a commercial plea for financial assistance to Defence that was, in part, based on a claim that: 'Material information was not disclosed to [CMG] during the tender and contractual negotiation stages', including details about the IT systems.¹⁰⁵ The commercial plea is discussed in Chapter 5.

3.32 Defence advised the ANAO that:

Defence initiated the commercial plea process with CMG in order to mitigate the material effect of any such shortcomings in the information that was available during the tender process. The intent was to remove any unreasonable financial impact on CMG.¹⁰⁶

3.33 As discussed in paragraph 3.17, Defence assumed that the previous contractor Manpower, as the incumbent and having trialled the New DFR model, would possess detailed knowledge of the intended operation of the New DFR Contract and would potentially be in an advantageous position with respect to the other tenderers. Thus, Defence needed to provide equitable

¹⁰⁵ Letter from Chandler Macleod Group to the Department of Defence, 30 January 2009, Part C Material non-disclosure, p. 4.

¹⁰⁶ Defence advice to the ANAO dated 31 May 2010.

access for all of the ITR respondents and shortlisted tenderers in terms of the amount and accessibility of information necessary for informed participation in the tender process. Tenderers were provided with access to documents in a data pack and data room and given relevant Internet addresses. However, based on Defence's own statements after the tender process was completed, it appears likely that the Manpower's knowledge of the contract in place at the time of the tender process exceeded Defence's in a number of critical areas. Defence was unable to fully address the imbalance during the tender process for the other tenderers due to gaps or weaknesses in the material provided in the data pack and data room.

3.34 The ANAO considers that Defence could reasonably have been expected to adequately prepare for a complex procurement such as the New DFR Contract, including having complete visibility of the operation of DFR before preparing the major procurement documents. Even though DFR is delivered as a collaborative arrangement, Defence is ultimately responsible for delivering personnel capability to the ADF.

Recommendation No.2

3.35 The ANAO recommends that, for any future Defence Force Recruiting services contract tenders, Defence undertakes sufficient preparation for the tender process so as to be in a position to provide tenderers with readily accessible, complete and accurate data to allow tenderers to make properly informed tender responses.

Defence response

3.36 *Agreed.* Defence is establishing a dedicated project team to plan and conduct the procurement project for DFR 2012—the contractual arrangement that will follow the Interim Contract with Manpower. This team will be led by a senior APS member with significant contracting expertise and experience in complex procurement.

Evaluation of tenders

Evaluation organisation

3.37 Defence's ITR evaluation organisation consisted of: an evaluation team, with the ability to draw on subject matter experts as required; external legal and probity advisors; an Internal Probity Officer; Steering Committee; and the Head of Defence's Personnel Executive, who was responsible for endorsing the

final ITR and RFT evaluation reports.¹⁰⁷ The RFT evaluation organisation was similar, with the addition of two external subject matter experts responsible for pricing and costing analysis and individual representatives from the single Services.

ITR evaluation

3.38 As shown in Table 3.1, 11 responses were received from the market in October 2007 to the ITR released in September 2007. The ITR was for the delivery of three work packages, marketing and recruiting services and EATS (later renamed JOS).¹⁰⁸ Defence shortlisted seven companies to proceed to an RFT.

Financial viability assessment

3.39 A core component of the ITR evaluation was an assessment of:
the financial and corporate viability of the requestor and any nominated subcontractor/s to deliver the required services, including the general standing of the requestor and its nominated subcontractors.¹⁰⁹

3.40 The assessment was a straightforward 'go/no go' assessment for which Defence required the ITR respondents to provide a range of financial information, including:

- audited financial statements for the previous three full financial years (together with profit and loss statements, balance sheets, cash flow statements, and notes to the accounts);
- details of any litigation or investigations (current, pending or threatened); and
- descriptions of insurance policies (public liability, professional indemnity and workers' compensation).

3.41 While the assessed financial viability risk of the eleven respondents varied from low to high, Defence did not exclude any of the respondents to the ITR on the basis of the overall assessment of their financial and corporate

¹⁰⁷ The evaluation team members were from Defence and the Project Advisor's organisation. The Steering Committee was chaired by the DGDfR with senior representatives from the single Services, Strategic Health Policy and Plans, Workforce Modelling Forecasting and Analysis, and Psychology areas in Defence, who were all members of the DFR Board of Management.

¹⁰⁸ See Figure 3.1 for a description of these three work packages.

¹⁰⁹ Department of Defence, *ITR Evaluation Plan*, September 2007, pp. 19–20.

viability (also see Chapters 4 and 5 for further discussion of the issues that subsequently arose in relation to CMG's financial viability).

RFT evaluation

3.42 The New DFR Contract deliverables—the services to be provided under the contract—were described in a SOW released to the tenderers in February 2008. The SOW specified that the contractor would be required to undertake five key functions under the New DFR Contract: DFR Management; Marketing functions; Recruiting functions; JOS; and Transition In and Transition Out (between DFR contracts).¹¹⁰ Defence made available a data room and data pack containing additional information to assist tenderers to prepare their responses. A briefing session for tenderers was held in February 2008 and a site visit to a DFRC in Parramatta, New South Wales, also took place in February 2008.

3.43 Defence received three tender responses in April 2008 based on a prime/subcontractor operating model (See Table 3.1). All three tenders were assessed as compliant with the conditions of the RFT and able to proceed to the evaluation stage.¹¹¹

Criteria

3.44 The RFT evaluation was based on a total of four evaluation criteria, of which three were assigned a weighting:

- The Tenderer's proposed approach in understanding and meeting the requirements of the RFT (*60 per cent weighting*);
- The Tenderer's capability and experience in providing services similar to those specified within the RFT (*38 per cent weighting*);
- The Tenderer's capability to transition in services without significantly affecting operational performance (*2 per cent weighting*); and

¹¹⁰ During the ITR, the Job Options Service was called the employment advice and transition service (EATS) (see paragraph 3.9).

¹¹¹ In this context, CMG noted that it subsequently transpired that the proposed IT system design included in its tender did not meet the applicable security standard for Defence Force Recruiting required under the Defence Security Manual, that is "xxx-in-confidence to be treated as Restricted" (Restricted Standard). Accordingly, CMG argued that its tender response should not have been assessed as compliant with the RFT. The issue of the non-compliance of the proposed IT system design included in CMG's tender with the requirements of the Defence Security Manual was not identified in the RFT Preliminary Source Evaluation Report or the IT Group assessment attached to this report. However, in any case, Defence reserved the right in the RFT to 'consider and accept, or reject, any tender, whether or not it is nonconforming and whether or not it is the lowest priced tender'.

- Total Contract Cost (*no weighting*).¹¹²

3.45 Defence used a comparative assessment and ranking method for the evaluation, based on both a quantitative and qualitative assessment of the tenders by the evaluation team. Defence also asked the tenderers to provide a written response to five scenarios addressing different aspects of the ADF recruiting operation. The aim of the scenario approach was threefold: to provide realistic examples for the tenderers of situations likely to occur in DFR; to minimise the incumbent's advantage; and, to assess the tenderers' understanding of Defence's requirements.

3.46 The evaluation team noted during the ITR that:

The majority of Submissions revealed a generally low level of understanding of the Defence context and, in some cases, the scope of the requirement. This will require the provision of substantially more general Defence information within the RFT documentation on which Tender responses can be based.¹¹³

3.47 Consequently, the RFT data pack contained a list of 31 general Internet information resources about DFR and Defence.

Evaluation report

3.48 At the end of the RFT evaluation phase, the Steering Committee finalised a *Preliminary Source Evaluation Report* (PSER) on 19 May 2008. The outcome of the RFT evaluation is presented in Table 3.3.

3.49 The PSER stated that the RFT evaluation team unanimously agreed that CMG represented best value for money overall for the Commonwealth and, due to overall risks, the third tenderer was deemed not suitable to be shortlisted. Manpower was assessed as capable of delivering the New DFR Contract.

¹¹² Department of Defence, *Request for Tender, Part 1 – RFT Conditions*, RFT No. NewDFR3/08, p. 26.

¹¹³ Department of Defence, *ITR Evaluation Report*, December 2007, p. 8. The Data Pack for the RFT included a list of 31 general Internet information resources for DFR and Defence.

Table 3.3**Outcome of the New DFR Contract Request for Tender evaluation**

Rank	Tenderer	Recommendation	Total Contract Cost (\$ Net Present Value)
1	CMG	Preferred tenderer	\$301 612 298
2	Manpower	Shortlisted tenderer	\$315 789 313
3	Third tenderer	Unsuccessful tenderer	\$301 762 766

Source: Department of Defence, *New DFR Recruiting Services Contract RFT Preliminary Source Evaluation Report*, 19 May 2008, p. 5.

3.50 On the basis of cost alone, CMG was ranked first, the third tenderer ranked second, and the Previous Contractor ranked third.

3.51 The PSER, in discussing Information Technology, commented that: ‘CMG’s response addressed all of the items specified regarding capability and experience in relevant IT activities.’¹¹⁴ There was no indication in this report of the issue that arose later regarding the security accreditation of CMG’s IT sub contractor (see paragraph 4.31).

Financial assessment component of RFT evaluation

3.52 The outcome presented in Table 3.3 was supported by a number of detailed assessments, for example, total contract risk, ability to negotiate a contract with Defence and transition to the contract. The following section discusses the financial assessment that underpinned Defence’s decision to select CMG to deliver the New DFR Contract.

Tender requirements

3.53 Central to determining value for money for the proposed contract was an assessment of the tenderers’ pricing responses. In their responses to the RFT, the tenderers were asked to estimate their costs and provide prices for the delivery of separate major categories of cost necessary to deliver the SOW (for example, labour and travel). The responses were to be based on a standard

¹¹⁴ Department of Defence, Defence Force Recruiting, *Preliminary Source Evaluation Report*, 19 May 2008, p. 31.

scenario and presented in a costing template that was provided as part of the RFT documentation.¹¹⁵

3.54 Tenderers were required to identify and explain the use of any assumptions that formed part of their pricing and costing response.¹¹⁶ All three tenderers submitted a list of assumptions with their tender responses. Further, one tenderer specifically referred to a number of instances where it considered Defence was unable to provide sufficient data to fully inform its tender response, including: a baseline or historical data for travel costs; telecommunications charges; and reimbursable facilities costs.¹¹⁷

Pricing model

3.55 As discussed in Chapter 2 (paragraph 2.14), Defence sought an increase in the fixed fee, and a corresponding reduction in reimbursable fees, under the New DFR Contract as compared to the previous DFR contract with Manpower. In addition, in the RFT Defence outlined its expectation for tenderers to calculate their pricing and costing responses on the basis that at least 50 per cent of the contract's revenue would be dependent upon recruitment achievement.¹¹⁸

¹¹⁵ The standard scenario used current DFR information which was considered would provide a realistic estimate of Defence's future recruitment needs for a five year period starting in July 2008. The approach was designed to produce a 'like with like' comparison and aid ranking of the tender responses. Additionally, by making the same background information and operating statistics available to all of the tenderers, Defence sought to overcome any advantage Manpower might have had by virtue of their incumbent position.

¹¹⁶ Department of Defence, *Request for Tender, Part 3 – Information to be Provided by Tenderers*, paragraph 20.1.7, p. 37.

¹¹⁷ This was the third tenderer.

¹¹⁸ Department of Defence, *Request for Tender, Part 3 – Information to be Provided by Tenderers*, paragraphs 20.7.2.6–20.7.2.7, pp. 50–51.

Tender responses

3.56 Financial advisors from the Project Advisor's organisation assessed the pricing and costing information submitted by the tenderers.¹¹⁹ The total cost of each of the three tenders is provided in Table 3.3. Given that Defence mandated the pricing framework for tenderers in the RFT, including prescribing an annual budgetary range for the five year period, it was expected that the tenderers' proposed total contract costs would be similar—approximately \$300 million—but not identical due to differing proposed business models. Defence's financial advisors concluded, from the detailed financial assessment, that the:

relatively narrow spread [of the tenderers' estimated total contract costs] indicates that all three tenderers have similarly interpreted the scope of work required and this gives greater confidence that the tender prices submitted by all three respondents are generally robust.¹²⁰

3.57 Defence's financial assessment of the tenders included analysis of the three tenderers' profit margins, proportion of 'at risk' revenue (linking payment to recruitment performance, rather than the fixed fee), and the break even point (what percentage of the recruitment target must be met to break even on costs under the contract). The PSER reported the following results:

- Profit margin—CMG charged a lower profit margin (10.43 per cent) than its competitors. [Manpower at 11.68 per cent and third tenderer at 16.95 per cent];
- At risk revenue—CMG put a higher proportion of its revenue at risk (59.63 per cent) than its competitors. [Manpower at 56.33 per cent and third tenderer at 48.29 per cent]; and

¹¹⁹ A full financial assessment report was attached to the PSER and detailed the results of the following analyses:

- Total cost of contract—breakdown by pricing element;
- Comparison of proposed pricing structures;
- Total cost of contract—sensitivity analysis; and
- Total cost of contract—analysis of costs.

Department of Defence, *New DFR Recruiting Services Contract RFT Preliminary Source Evaluation Report*, 19 May 2008, Enclosure 3, Pricing and Costing Evaluation.

¹²⁰ Department of Defence, *New DFR Recruiting Services Contract RFT Preliminary Source Evaluation Report*, 19 May 2008, Enclosure 3, Pricing and Costing Evaluation, p. 6.

- Breakeven point—CMG had the highest breakeven point (86.26 per cent of the assumed [recruitment] target) providing a strong incentive to meet the recruitment targets. [Manpower at 81.34 per cent and third tenderer at 71.82 per cent].¹²¹

3.58 The ANAO acknowledges that performance under the previous DFR contract and the New DFR Contract are not directly comparable due to changes in the risk apportionment and pricing schedule. Further, Defence expected that recruitment achievement under the New DFR Contract would be improved by the introduction of the New DFR model and increased Government funding for ADF recruitment and retention initiatives (see Chapter 1, paragraph 1.3).

3.59 Nevertheless, while Defence accurately identified that a higher break even point is a strong incentive for performance by a contractor and a lower profit margin can represent better value for the Commonwealth, there needed to be recognition also that changes to the recruitment target set by Defence can have the result of lowering a contractor's potential revenue and thus affecting its financial viability. The interaction of the pricing strategy put forward by a tenderer and reductions in the recruitment targets can have an impact on a tenderer's revenue if it is successful in winning the tender. Reductions in revenue to tenderers which could result from lower targets can affect a firm's later financial viability (if successful in their tender).

3.60 For pricing purposes, the standard scenario in the RFT was based on an annual target of 10 500 ADF recruits per annum. The annual recruitment target for 2009–10 was subsequently set at 9280, which is 11.6 per cent lower than the RFT standard scenario target.

3.61 In Chapter 2 there is discussion of the opportunity to change to the pricing model for DFR services in future contracts that would reduce risk to Defence. This proposal would involve tenderers in any future tendering process being invited to put forward part of the fees element of their pricing strategies on a sliding scale, assuming different levels of recruitment targets.

¹²¹ Department of Defence, *New DFR Recruiting Services Contract RFT Preliminary Source Evaluation Report*, 19 May 2008, pp. 38–39.

Sensitivity analysis

3.62 The tender evaluation focussed on the potential for improved performance under the New DFR Contract from Defence's perspective. A sensitivity analysis, performed as part of the financial assessment, considered the expected financial impact upon Defence's budget compared to potential achievement of the recruitment target by the individual tenderers (on a scale of achievement from 0–100 per cent).

3.63 The analysis did not consider the impact on the tenderers' expected profit margin of variation in the annual recruitment target set by Defence, nor did the analysis consider the effect sub-optimal performance by CMG, or Defence¹²², during the contract's five year term could have on CMG's break even point. However, not achieving the contractor's estimated break even point under the New DFR Contract would have implications for the contract's commercial viability.

3.64 In any future tender evaluation related to outsourced ADF recruitment services, there would be benefit in Defence undertaking an assessment of how robust the pricing proposals of tenderers would be under varying scenarios, including changes to annual recruitment targets.

Financial risks for Defence

3.65 A number of financial risks were identified for Defence during the financial assessment of tenderers' responses to the RFT, relating to the quality of RFT documentation, adjustments to raw bids during tender assessment and potential variations in reimbursables.¹²³

3.66 Defence acted to mitigate its financial risk during the tender process, prior to taking further steps aimed at managing risk during the contractual negotiation process (see paragraphs 3.77 and 3.78). The steps taken during the tender process involved:

- engaging the services of a Project Advisor, with access to financial expertise, to provide the necessary expertise in Defence procurement not available within DFR Branch;

¹²² As discussed in Chapter 2, the achievement of recruitment targets is not solely determined by the performance of Defence's prime contractor.

¹²³ Department of Defence, *New DFR Recruiting Services Contract RFT Preliminary Source Evaluation Report*, 19 May 2008, Enclosure 3, Pricing and Costing Evaluation, pp. 17–18.

- engaging the services of another external consultant to develop an economic model—to support the implementation of the New DFR model—that was then used for the RFT financial assessment;
- establishing a representative Steering Committee to guide the procurement process comprised of Defence stakeholders that were expected to have relevant and sufficient knowledge of procurement and the operation of DFR; and
- gaining endorsement from the Steering Committee and the Defence delegate, who would sign the New DFR Contract for the PSER, that documented the outcomes of the RFT evaluation.

3.67 CMG also accepted a level of risk by agreeing to enter into the New DFR Contract on the basis of its proposed pricing model in its tender response. CMG's fees under the proposed contract, the majority of which were performance based, were subject to the effectiveness of the collaborative recruitment arrangement with Defence and potential changes to target recruitment levels.

Contractual negotiation

3.68 On 26 May 2008, Defence's Deputy Secretary, People Strategies and Policy, endorsed the selection of CMG as the preferred tenderer for the New DFR Contract.¹²⁴ The final stage in the procurement for the New DFR Contract was the negotiation process Defence undertook with CMG, which took place from May to July 2008. The remaining sections in this chapter set-out the major activities undertaken by Defence during the contractual negotiation phase.

Contract negotiation directive

3.69 In accordance with the requirements in the DPPM, the delegate (see footnote 124) also approved a negotiation directive for the contract that provided the necessary guidance and authority for Defence's negotiation team to conduct appropriate negotiations with CMG as the preferred tenderer.¹²⁵

¹²⁴ The Deputy Secretary People Strategies and Policy was the Defence official holding an appropriate financial delegation to authorise signing of the New DFR contract in accordance with the *Financial Management and Accountability Act 1997* and Defence's *Chief Executive Instructions*.

¹²⁵ Defence's negotiation team was led by the then DGDFR and supported by subject matter experts in the areas of: legal and financial matters; negotiation strategy; information technology; and medical matters.

3.70 Defence considered that the Commonwealth was in a strong position entering the negotiations due to the highly competitive nature of the shortlisted tenders, the perceived desirability of securing a large and prestigious recruiting contract in Australia and the overall commercial value and potential length of the New DFR Contract.

3.71 The negotiation directive listed three key areas for negotiation between Defence and the preferred tenderer:

- reduction of risk to Defence;
- the prospect of improved value for money; and
- exploring opportunities to reach agreement about non-compliances against Defence's RFT conditions or requirements the RFT evaluation team had noted relating to the preferred tenderer's proposal (see Table 3.4).¹²⁶

3.72 If required, Defence had the ability to negotiate with Manpower—who was assessed as having a strong understanding of and capability and experience to deliver the New DFR Contract requirements. However, Defence did not take up this option. Defence's view was that CMG offered: 'industry experience, innovation and an energy which was assessed as able to deliver long term value to Defence and improvement in the recruitment of ADF personnel' while the Manpower's tender response: 'presented a safe and conservative approach to the New DFR Contract, however reflected a potential "business as usual" approach to delivering the services in the future.'¹²⁷

Process

3.73 On 27 May 2008, Defence advised CMG that it had been shortlisted for the New DFR Contract and was invited to participate in a negotiation process.¹²⁸ Defence further advised CMG that its intention was to execute a New DFR Contract on or before 30 June 2008, which meant there was approximately one month available for contractual negotiations. Defence conducted the New DFR Contract negotiation process with CMG via email, letter, telephone and face-to-face meetings.

¹²⁶ Department of Defence, *Contract Negotiation Directive*, 26 May 2008, p. 4.

¹²⁷ Department of Defence, *Brief for Deputy Secretary People Strategies and Policy and Head Personnel Executive*, 22 May 2008, p. 1.

¹²⁸ The other two tenderers were also advised of the outcome of the RFT on 27 May 2008.

Outcomes

3.74 Defence and CMG negotiated on 54 separate items. Defence achieved its optimum position in 41 instances; an acceptable position for 10 items; and, a fallback position for three items (see note to Table 3.4 for the definitions of these terms).

3.75 Defence's view was that:

Defence held a firm stance during procurement and contract negotiation activities as a result of the highly competitive position it was in and Defence's intent to meet established timelines. As a result, CMG presented significant flexibility in their enthusiasm to win the contract.¹²⁹

3.76 Defence sought to resolve a number of outstanding non-compliances and areas identified by Defence during the RFT evaluation as being of concern in CMG's RFT response.¹³⁰ Table 3.4 shows the negotiation position Defence achieved in relation to the six significant areas of non-compliance of CMG's proposal with the proposed New DFR Contract identified by Defence during the evaluation of the tenderers' RFT responses.

Table 3.4

Significant RFT non-compliances and contractual negotiation outcome

Area of non-compliance	Description	Defence negotiation position achieved ^A
Validity of assumptions	CMG sought the ability to re-open aspects of its tender and any resulting contract if it became apparent that the assumptions on which its offer was based were invalid.	Optimum
Price and work variation	CMG indicated that it would seek requirements that any scope variation be made in 'good faith' and 'reasonably'. In addition, all price adjustments were to be subject to dispute resolution processes or referral to an independent third party for determination.	Acceptable

¹²⁹ Department of Defence, Minute DGDFR/OUT/2009/35, *DFR Response to CMG Submission Without Prejudice*, 19 February 2009, p. 3.

¹³⁰ These non-compliances and areas identified as being of concern in CMG's RFT response were considered by Defence to be capable of resolution by negotiation such that CMG's response was then either compliant or an acceptable amendment could be arrived at to clarify matters.

Area of non-compliance	Description	Defence negotiation position achieved ^A
Bank undertaking	CMG proposed a financial undertaking in the amount of \$2 million (while \$5 million was specified in the RFT).	Optimum
Liability	CMG proposed that its overall liability under the contract, including contractual indemnities, be limited to \$20 million in aggregate. In addition, a total exclusion of liability for loss or damage of an indirect, special, economic or consequential nature was sought. ^B	Optimum
Transition out costs	CMG proposed a right to be reimbursed costs it incurred in respect of transitioning out of the contract.	Optimum
Suspension of performance/termination	CMG proposed an express right for it to suspend performance or terminate the contract on breach by the Commonwealth.	Optimum

Notes: (A) Defence's definitions for the negotiation positions achieved were:

- Optimum—Rejection to any amendment of the risk allocation or provisions put forward in the Contract and its various schedules. Confirmation of Defence's position.
- Acceptable—Some amendment to provisions where the result was a clarification of the intent or obligations required within the clause.
- Fallback—Defence's 'concessionary position' which may include:
 - some acceptable restriction of the broad-ranging flexibility to act unilaterally; or
 - a limitation of the risk to which the Tenderer may be exposed; or
 - an increase in the risk allocation to Defence where such an increase is within Commonwealth policy, does not impact overall value for money and may only occur in areas considered to be of overall low risk to Defence.

(B) Defence's Legal Advisor noted that the proposal was not compliant with standard Commonwealth policy and practice for limiting liability.

Source: ANAO analysis of Department of Defence, *New DFR Recruiting Services Contract, RFT Final Source Evaluation Report*, 27 June 2008, pp. 6 and 9–45 and Department of Defence, *New DFR Recruiting Services Contract RFT Preliminary Source Evaluation Report*, 19 May 2008, Enclosure 2, section 2.2.

3.77 Table 3.4 shows that Defence conceded its original negotiating position back to an 'acceptable' outcome (a beneficial amendment to the proposed contract) in response to CMG's requirement that any scope change—in the form of price and/or work variations—be made in 'good faith and reasonably'. Defence achieved an 'optimum' negotiation position (no change) for the remaining five significant areas of non-compliance.

3.78 The outcome presented in Table 3.4 meant that Defence's risk profile for the delivery of the New DFR Contract was unchanged. CMG was unable to

secure Defence's agreement to its preferred position on a number of matters, including, from Defence's perspective, a significant change to the risk profile of the contract included in the RFT, such that CMG would have the ability to re-open aspects of its tender response and any resulting contract, if it became apparent that the assumptions underpinning its RFT response were invalid.

Risk management

3.79 The CPGs advise that: 'As a general principle, risks should be borne by the party best placed to manage them'.¹³¹ The 2006 consultant's evaluation commissioned by Defence of the DFR model and contract then in place concluded that this contract allocated the risk for achievement of recruitment outcomes to the contractor, with Defence retaining minimal risk.

3.80 In discussing innovation in the public sector, Matthews argues that governments place too great an emphasis on the 'management of risk' and not enough emphasis on the 'management of uncertainty'.¹³² This distinction between uncertainty and risk is important in the case of the New DFR Contract as factors such as changes in economic conditions (or Defence's recruitment requirements or budgetary policy), are examples of uncertainties that government rather than a private sector contractor is best placed to manage.

3.81 Clause 31 of the New DFR Contract indicates that Defence retained the ability to exercise certain functions for defence purposes. Defence's 'retained functions' were defined as the rights, powers, functions, activities and responsibilities specified in the contract's SOW and any other functions stated elsewhere in the contract to be retained functions. The definition covered a Defence call centre receiving initial inquiries, as well as DFR ADF personnel providing career advice, interviewing and selecting recruits. In addition, Clause 31 provided that Defence:

will not (except as otherwise expressly provided in this Contract) be liable to the Contractor upon any Claim arising out of or in connection with the exercise or failure to exercise any Retained Function in any particular manner or at all (including any Claim arising out of or in connection with any fluctuation in the required volumes of and all delays and disruptions to the

¹³¹ Department of Finance and Administration, *Commonwealth Procurement Guidelines* Financial Management Guidance No.1, Finance, Canberra, 2005, p. 14.

¹³² *Critical Reflections on Australian Public Policy: selected essays* (editor John Wanna). 6. Fostering creativity and innovation in cooperative federalism – the uncertainty and risk dimensions (Mark Matthews) p. 59.

New DFR Contract Services arising out of or in connection with the exercise or failure to exercise any Retained Function in any particular manner at all).¹³³

3.82 Clause 31 also provided that the Contactor acknowledged that:

- it will bear the risk of all fluctuations in the required volumes of all delays and disruptions to the New DFR Contract; and
- it has made a full allowance in preparing its tender for all costs, expenses, losses and damages which it could incur or suffer arising out of, or in connection with, any fluctuation, delay or disruption.

3.83 Underpinning Defence's approach to the contractual negotiations with CMG, and pricing structure established within the New DFR Contract, was Defence's aim of limiting the risk to its budget by reducing its exposure under the New DFR Contract to claims from the contractor for reimbursement of costs, in contrast to the more generous reimbursement provision of the previous DFR contract. Consequently, under the New DFR Contract, all costs not explicitly covered in the contract were considered to be the contractor's responsibility. While Defence's objective in this process (limiting budgetary pressures) was desirable, the fundamental collaborative nature of the arrangement between Defence and its selected contractor also needed to be recognised.

3.84 In designing a contract and pursuing contract negotiations, it is important to recognise that assigning risks to a contractor without it being in a position to properly mitigate these risks, and thus reduce their likelihood of coming to fruition, is likely to affect the contractor's pricing approach, and potentially a contract's viability if the contractor does not price risk appropriately. In such circumstances, the contractor may well seek to add extra into their pricing to offset the risks associated with not being able to fully control the delivery of outcomes. If the contractor is not successful in accurately assessing the potential cost of assuming these risks, the commercial viability of the contract may be undermined thus increasing the potential that the contractor may fail to deliver the expected outcomes and experience financial hardship. Given the collaborative nature of the contracting relationship Defence has sought in successive contracts with prime contractors providing recruiting services for the ADF, it is prudent to make sure that there is a clear distinction between those risks which are the sole responsibility of

¹³³ Department of Defence, *New DFR Recruiting Services Contract*, July 2008, p. 57.

one party or the other to manage, and those risks that, given the contract's fundamental collaborative essence, need to be managed jointly.

3.85 CMG ultimately signed the New DFR Contract as negotiated with Defence, accepting the risk involved. Thus Defence was entitled to expect that the contract would be fulfilled on the terms set down. However, the ANAO notes that the level of risk transferred to, and accepted by, CMG did not match its capacity to manage some of the risks given the extent to which the activities and success of the two parties in carrying their respective responsibilities were intertwined, with both parties contributing to the contractually required outcomes.

3.86 As noted in paragraph 3.79, the CPGs note the general principle that risks should be borne by the party best placed to manage them. Accordingly, it is not uncommon for agencies to seek to achieve some level of risk transfer to contractors under service delivery contracts so as to ensure that, as far as practicable and cost effective, this outcome is achieved as an underpinning to effective risk management. In the case of the New DFR Contract, while CMG accepted the risk apportionment negotiated by Defence, and did not seek an additional premium to compensate it for this, it remained the case that the contractor was not well placed to manage a range of risks that related to actions required by Defence. This situation contributed to the eventual termination of the New DFR Contract (see paragraphs 5.64 to 5.66).

3.87 Where factors affecting the operation of a contract require the 'management of uncertainty' (such as changes to economic conditions or government policies), there is a case for the department to retain responsibility for managing such factors, or at least frame its contractual arrangements such that the full impact of the uncertainty does not fall on its private sector partner.

3.88 Accordingly, in any future tender process for a contract to deliver DFR services, there would be benefit in Defence having tenderers submit some elements of their pricing proposals on a sliding scale dependent on the level of target recruitment would help make the risk transferred to the contractor more manageable by that party (refer to discussion in Chapter 2, paragraphs 2.38 to 2.40). Having such an arrangement need not involve an increase in reimbursement costs and therefore should not reduce Defence's ability to maintain control over DFR contracting costs.

Contract signature and other matters

3.89 The Final Source Evaluation Report (FSER) on the RFT responses recommended that, on the basis of value for money and the acceptable risk position achieved by Defence during the contract negotiation process, CMG's tender be accepted. The delegate was advised that the total value of the New DFR Contract over its five year term was up to:

- Contract value \$368 164 160 (GST exclusive);
- GST \$36 816 416; and
- Total contract cost \$404 980 576 (GST inclusive).¹³⁴

3.90 On 1 July 2008, Defence advised the then Minister for Defence Science and Personnel that all of the documentation required before contract execution for the New DFR Contract had been completed. The final expenditure approvals were consistent with the requirements of the FMA Regulations.

3.91 The New DFR Contract was executed on 2 July 2008 between Defence, on behalf of the Commonwealth, and CMG. Also on 2 July 2008, the then Minister for Defence Science and Personnel announced the signing of the contract and that it was valued at: 'up to \$405 million over the next five years ... [to] commence on 1 February 2009'.¹³⁵

3.92 Later in July 2008, after the New DFR Contract was executed, Defence provided separate debriefing sessions to the two unsuccessful RFT tenderers.

3.93 The ITR and RFT documentation advised respondents that participation in those processes was to be at the respondent's sole risk, cost and expense. The ANAO was advised by one of the three tenderers that their estimated cost for participation in the DFR tender process in 2007–08 was in excess of \$1 million.

¹³⁴ The price adjustment mechanism specified in the total contract cost is the Consumer Price Index (CPI). This was a maximum cost assuming target recruitment levels of 10 500 per annum and that the contractor achieved 100 per cent of the target.

¹³⁵ Minister for Defence Science and Personnel, the Hon. Warren Snowdon MP, Media Release *New Contract to Support ADF Recruiting* [Internet]. Department of Defence, Canberra, 2 July 2008, available from <<http://www.Defence.gov.au>> [accessed 18 August 2009].

Absence of ANAO access provisions in the contract

3.94 The 2003–04 ANAO audit of DFR suggested that: ‘when developing future contractual arrangements for the provision of recruiting services, the inclusion of appropriate access clauses [for ANAO audit purposes] would strengthen accountability and aid contract management by DFR.’¹³⁶ In response to the audit, Defence:

agreed that future contracting arrangements should include appropriate access clauses. DFR will implement the approach advocated in the Defence Procurement Policy Instruction [*Australian National Audit Office Access Provisions*, Instruction No 1/2003, 7 January 2003] relating to ANAO access for audit purposes.¹³⁷

3.95 The CPGs at the time the New DFR Contract was being developed advised agencies that, where relevant, there should be a provision in contracts to enable the ANAO to access contractors’ records and premises for audit purposes.¹³⁸ The DPPM stated that: ‘Where a contract provides for the provision of outsourced services, specific clauses allowing for direct ANAO access will usually be required.’¹³⁹ The New DFR Contract did not contain specific provisions for the ANAO to access CMG’s premises and records.

3.96 Given the DFR contract is a significant Defence contract for the provision of outsourced services to the ADF, the ANAO’s previous audit findings and Defence’s agreement to them, and the likelihood of future ANAO audits of DFR, there are sound reasons for including ANAO access provisions in any major DFR contract. Including ANAO access provisions in major DFR contracts could also assist Defence with its contract management role.¹⁴⁰

¹³⁶ Australian National Audit Office 2003, *Australian Defence Force Recruiting Contract*, Audit Report No.10 2003–04, ANAO, Canberra, p. 54.

¹³⁷ Australian National Audit Office 2003, *Australian Defence Force Recruiting Contract*, Audit Report No.10 2003–04, ANAO, Canberra, p. 54.

¹³⁸ Department of Finance and Administration, *Commonwealth Procurement Guidelines* Financial Management Guidance No.1, Finance, Canberra, 2005, p. 20.

¹³⁹ Department of Defence, *Defence Procurement Policy Manual*, Version 6.0, Defence, Canberra, 2006, p. 6.2.10.

¹⁴⁰ The Department of Finance has published material on ‘Standard Contract Clauses to Provide ANAO Access to Contractors’ Information’ on its web site that is available from <<http://www.finance.gov.au/>>.

Recommendation No.3

3.97 The ANAO recommends that Defence includes access provisions in its major Defence Force Recruiting contracts to enable access by the ANAO to prime and subcontractors' records and premises for audit purposes.

Defence response

3.98 *Agreed.* This recommendation has been referred to the DFR 2012 project team for implementation.

4. Managing Contract Transition

This chapter examines Defence's management of the 'transition out' of Manpower and the 'transition in' of CMG for the New DFR Contract over a seven month period from early July 2008 to late January 2009.

Introduction

4.1 Chapter 3 described events leading to signing of the New DFR Contract by CMG on 2 July 2009. However, the new contractor did not assume full responsibility for the delivery of recruitment services under the contract until 1 February 2009.

4.2 Defence was aware a significant transition period would be required if the incumbent service provider was not successful in securing the New DFR Contract. In order to avoid any interruption to the operation of DFR, Defence intended that the period from 2 July to 31 October 2008, would be used as a familiarisation and establishment time for CMG to plan for the transition process, before a phased handover of responsibilities from Manpower to CMG over the period from 1 November 2008 to 31 January 2009.¹⁴¹

4.3 This chapter examines Defence's administration of the transition period including the:¹⁴²

- governance framework and contractual requirements;
- management of major transition activities; and
- minimisation of any impact on recruitment performance.

Governance framework and contractual requirements

Governance framework

4.4 To oversight and support the transfer of business operations between contractors, Defence established a hierarchical framework of committees to manage the transfer and ensure minimal disruption to recruitment

¹⁴¹ Defence managed separate contracts with both providers during the seven month transition period while the knowledge, assets and operations required to support the DFR services contract were transferred between the contractors.

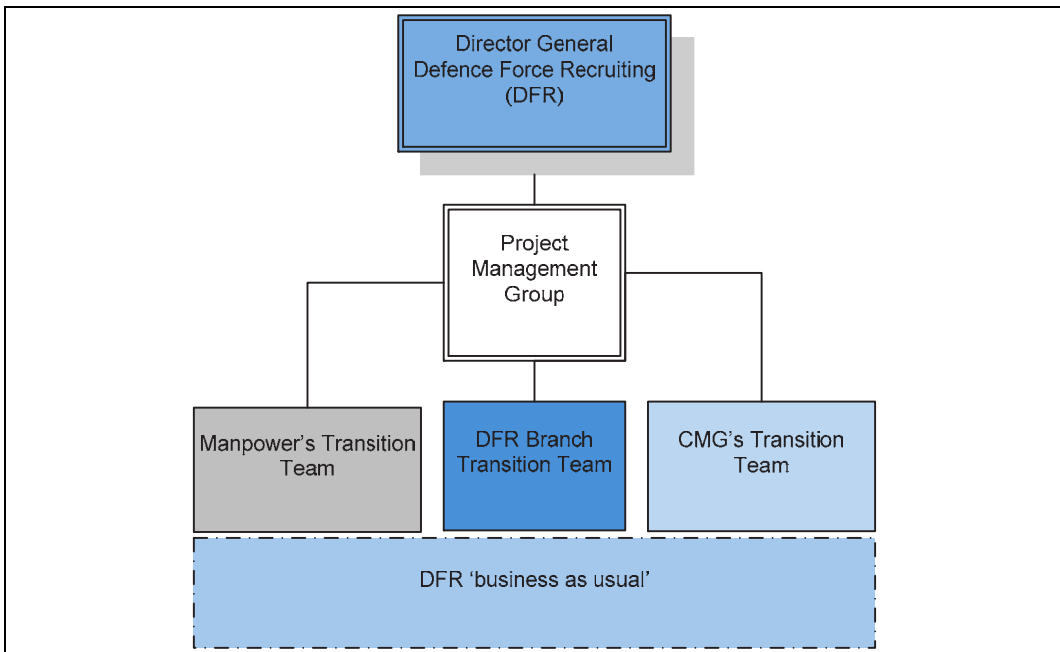
¹⁴² The analysis included consideration of relevant sections from the DPPM and the joint ANAO/ Finance Better Practice Guide, *Developing and Managing Contracts*, February 2007.

achievement and activities. Figure 4.1 shows the various committees that reported to the DGDfR. The transition organisation operated on two levels:

- Tier 1: a Project Management Group consisting of a senior representative from each of the three parties—DFR Branch, the Previous Contractor and CMG; and
- Tier 2: a transition team for each individual party.

Figure 4.1

Transition Organisation



Source: ANAO analysis, 2009, adapted from Department of Defence, *Transition Project Charter for the DFR Transition Phase*, 23 September 2008, p. 7.

4.5 The DFR Branch Transition Team shown in Figure 4.1 was responsible for: ‘the planning and management of the activities required to effect a smooth transition from the previous provider to the incoming provider,’¹⁴³ including facilitating communication between CMG and Manpower.

¹⁴³ Department of Defence, Draft *Disengagement Management Plan for the DFR Transition Phase*, July 2008, p. 5.

4.6 Defence's management of the major transition period activities is further discussed in the next section, with a focus on the activities of the DFR Branch Transition Team (Transition Team).

Contractual requirements

4.7 It is common for service delivery contracts to include formal transition in and transition out arrangements to ensure the continued effective delivery of services.¹⁴⁴ Where a transition in period is required, the contract should specify the period of the transition and detail the contractor's responsibilities.¹⁴⁵ In the case of the New DFR Contract, the transition period represented a high risk to the operational efficiency of DFR.

4.8 The New DFR Contract, and the previous DFR contract, specified requirements for the transition in and transition out of the respective contractor's services. The New DFR Contract specified that CMG was required to: 'prepare the Transition In Plan so that it is consistent and co-ordinates with, and complements, the Previous Contractor's transition out plan.'¹⁴⁶ The Previous Contractor, Manpower, was required to prepare a transition out plan while continuing to provide recruiting services during the transition out period without disruption.

4.9 Both contractors provided transition plans in accordance with their contractual requirements. Defence also produced a set of key planning documents to manage disengagement and risk and support effective communication. A *Transition Project Charter* was the umbrella document that covered the transition's objective, scope, governance and administrative arrangements.

4.10 In addition to a risk management plan, Defence also developed and maintained an extensive risk register of the issues expected to occur and those that arose during the transition period. Additionally, CMG was required to: 'prepare and deliver to Defence a weekly Transition In status report'.¹⁴⁷

¹⁴⁴ Australian National Audit Office and Department of Finance and Administration, *Better Practice Guide—Developing and Managing Contracts*, February 2007, ANAO, Canberra, p. 42.

¹⁴⁵ Australian National Audit Office and Department of Finance and Administration, *Better Practice Guide—Developing and Managing Contracts*, February 2007, ANAO, Canberra, p. 43.

¹⁴⁶ Department of Defence, *New DFR Recruiting Services Contract*, 2 July 2008, Contract Conditions, Part 2, paragraph 6.1(a), Transition In Plan, p. 12.

¹⁴⁷ Department of Defence, *New DFR Recruiting Services Contract*, 2 July 2008, Attachment 5, Statement of Work, Contractor Requirements, (d)(xii), p. 224.

Defence's records show that regular reports were received that met Defence's requirements.

Schedule

4.11 As described in paragraph 4.2, Defence originally intended the actual handover of DFR operations (recruiting, marketing and management) to take place from 1 November 2008 to 31 January 2009.

4.12 Following initial planning in early August 2008 by Manpower and CMG to align the respective contractors' transition plans, and subsequent discussions between CMG and Defence, CMG proposed that the transition be conducted in two phases rather than three as originally proposed. After considering the risks and benefits of the proposal, the DGDfR approved the proposed change to the transition in schedule in September 2008. Defence identified the benefits of the alternative phasing to be:

- small/medium DFRCs in the first phase utilised as a pilot; and
- time between the phases provides an opportunity to assimilate lessons learnt into the second phase.¹⁴⁸

4.13 Table 4.1 shows the original transition in schedule in the New DFR Contract and the revised schedule that was to be implemented by Defence and the contractors.

¹⁴⁸ Department of Defence, Variation Notice Deed Number 007/2008, *Amendment to the Transition in Schedule*, 25 September 2008.

Table 4.1**Transition in schedule 2008–09: planned and actual**

Timeframe	Original activity (New DFR Contract)	Revised activity (Variation notice) ^A
1 July 2008	Transition commencement	Transition commencement
1 July 2008–31 October 2008	Transition planning/familiarisation	Transition planning/familiarisation
1 November 2008	<u>Phase 1:</u> Commence transition of CRMC, marketing and DFRCs at Brisbane, Cairns, Coolangatta, Maroochydore, Toowoomba, Townsville	<u>Phase 1:</u> Commence transition of CRMC, marketing, training, quality assurance functions and facilities and DFRCs at Adelaide, Darwin and Hobart
1 December 2008	<u>Phase 2:</u> Commence transition of DFRCs at, Adelaide, Albury, Darwin, Hobart, Melbourne	
1 January 2009	<u>Phase 3:</u> Commence transition of DFRCs at Canberra, Newcastle, Parramatta, Perth Wollongong	<u>Phase 2:</u> Commence transition of DFR HQ and DFRCs at Albury, Brisbane, Cairns, Canberra, Coolangatta, Maroochydore, Melbourne, Newcastle, Parramatta, Perth, Toowoomba, Townsville, Wollongong
No later than 12 January 2009	Commence transition of HQ and IT services	Commence transition of HQ and IT services
31 January 2009	Transition complete	Transition complete

Note: (A) Department of Defence, Variation Notice Deed Number 007/2008, *Amendment to the Transition in Schedule*, 25 September 2008.

Source: ANAO analysis, 2009.

4.14 As shown in Table 4.1, the revised Phase 1 activities for transitioning facilities in Melbourne (CRMC), Adelaide, Darwin and Hobart (DFRCs) was scheduled to be completed by 1 December 2008. However, Defence and CMG were in disagreement about the extent and nature of GFE (see paragraphs 4.26–4.27 for further detail), which meant that insurance coverage was not obtained by CMG such that the transition could occur on either 30 November or 1 December 2008.

4.15 When the transfer of the facilities did not occur, Defence invoked a contingency plan that required Manpower to maintain control of the Phase 1 assets until the new lease arrangements were confirmed or until close of

business 5 December 2008, whichever was the earlier.¹⁴⁹ One facility was transitioned on 30 November 2001, with the remaining three Phase 1 facilities transitioned on 5 December 2008. The Phase 1, marketing, training and other operations were transitioned by 30 November 2008.

4.16 Phase 2 and other activities were generally completed in the period up to 31 January 2009. In some cases leases were not transferred to CMG and instead new leases were entered into.

Payments

4.17 Sound management practice for making contract payments involves a number of steps including ensuring:

- payments are in accordance with the provisions of the contract;
- services were provided and to the required standard;
- the request for payment (invoice or other statement of expenditure) is correct;
- payments are timely; and
- necessary agency authorisations and approvals have been obtained before making payment.¹⁵⁰

4.18 While Defence continued to pay Manpower to deliver recruiting services during the transition period according to the previous contract's pricing schedule, Defence also made payments to CMG of \$1.1 million per month from July 2008 to January 2009 in accordance with the New DFR Contract (a total of \$7.7 million).

4.19 The transition payments were made in lieu of the fixed and per head fees that would be payable once CMG assumed full responsibility for the delivery of services. CMG's transition in obligations also included: preparation of a transition in plan in accordance with the contractual requirements (see paragraph 4.8); and, completing the transfer of assets and existing contracts from either Defence or Manpower to CMG.¹⁵¹

¹⁴⁹ Department of Defence, *CA Notice CM 25/2008 – Phase 1 Transition of Facilities*, 1 December 2008.

¹⁵⁰ Australian National Audit Office and Department of Finance and Administration, *Better Practice Guide—Developing and Managing Contracts*, February 2007, ANAO, Canberra, p. 81.

¹⁵¹ Department of Defence, *New DFR Recruiting Services Contract*, 2 July 2008, Part Two – Transition In Obligations, pp. 12–14.

4.20 The ANAO compared the schedule of transitional adjustment payments required to be made by Defence to CMG under the New DFR Contract with summary DFR reporting data.¹⁵² After receiving a detailed explanation of the operation of the payments system, including the approvals process and recordkeeping procedures, the ANAO was satisfied as to the robustness of the processes surrounding the payment system for transition payments made to CMG. Because it was outside the scope of the audit, the ANAO did not conduct a detailed examination of the overall DFR payment system.

Management of major transition activities

Transition Team

4.21 Defence anticipated that the DFR Branch Transition Team would, initially, meet formally on a weekly basis.¹⁵³ Starting on 4 August 2008, and ending on 27 January 2009, the Transition Team generally followed a weekly schedule of meetings. The meeting agendas each followed a similar format that included discussion of: actions; updates; monitoring and reporting on transition risks; and a list of ongoing transition issues that were monitored by the Transition Team.

Major issues

4.22 As discussed in paragraph 4.10, Defence maintained a risk register during the transition period. Defence informed the ANAO that there were 45 separately identified risks managed by the Transition Team during the transition period.¹⁵⁴ The following are examples of some of the issues recorded in the register:

- requirement for details of third party contracts for the IT systems;
- clarifying the ownership of medical assets and determining medical GFE;

¹⁵² Department of Defence, *New DFR Recruiting Services Contract*, 2 July 2008, Attachment 7, Pricing Schedule, Annexure 5 – Transitional Adjustment Payments, p. 291.

¹⁵³ Department of Defence, *Transition Project Charter for the DFR Transition Phase*, 23 September 2008, p. 10.

¹⁵⁴ The Project Management Group discussed a similar range of issues and risks to those discussed by the Transition Team.

- lease arrangements for DFR facilities;
- responsibility for the ‘make good’ requirements for leased facilities; and
- arrangements for leasing motor vehicles.

4.23 Defence informed the ANAO that at the end of January 2009 there were 13 unresolved/ongoing issues in the transition risk register.

4.24 The Transition Team also monitored key personnel matters during the transition period, including the movement of employees from the Previous Contractor to CMG. The transfer of personnel resulted in: ‘over 90 per cent [approximately 350] of Manpower’s staff, including all Area and Centre Managers, several key executives and the majority of the Headquarters and centre [DFRC] junior staff agreeing to transfer to CMG.’¹⁵⁵ Defence considered that CMG’s selected offers of employment to Manpower’s personnel: ‘effectively mitigated the knowledge transfer risk and ensured a seamless transition for day to day operations.’¹⁵⁶

Facilities and IT systems

4.25 Of the issues that Defence managed during the transition period, the two most challenging were those surrounding DFR’s IT systems and facilities’ arrangements. These two items were sufficiently significant that additional meetings were held to discuss each issue and separate minutes were maintained for those meetings.

Transition of facilities

4.26 A number of issues were grouped under the heading ‘facilities’:

- establishing accurate records of GFE—a series of stocktake meetings to validate the GFE lists in terms of quantity, location and serviceability were conducted at CMG’s request;

¹⁵⁵ Department of Defence, *Defence Force Recruiting, Transition–In Report*, 4 May 2009, p. 8. In other Defence documents, the number is reported as being as high as 96 per cent of the Previous Contractor’s workforce that accepted an offer of employment with the Prime Contractor.

¹⁵⁶ Department of Defence, *Defence Force Recruiting, Transition–In Report*, 4 May 2009, p. 8.

- ‘make good’ requirements for facilities—the question of liability for make good costs was not addressed during the tender process and therefore was not budgeted for by CMG;¹⁵⁷
- ‘fit out’ for new facilities—clarifying the payment arrangements for any new relocation and fit-out costs incurred by CMG for DFR facilities; and
- arrangements for facility leases—including for two leases described by Defence during the tender process, but not adequately detailed in the New DFR Contract as existing facility leases to be novated to CMG.¹⁵⁸

4.27 The two leases referred to in paragraph 4.26 were in Townsville and Cairns in Queensland. In January 2009, Defence advised CMG that:

While the leases for both floors of the Cairns property were included in the data room during the RFT process, the indicative rental price was understated by approximately \$112 000 in Defence’s response to [RFT] clarification question 117. Of note, however, is that in the same clarification question, the indicative rental prices provided for Brisbane and Maroochydore were overstated by approximately \$120 000.

On this basis, Defence has determined that the contract price does not require adjustment as the understatements and overstatements in clarification question 17 cancel each other out.¹⁵⁹

4.28 In May 2009, Defence finalised a report documenting the outcomes from the transition period and lessons learned (see paragraph 4.56). The report stated that:

Defence has no facilities staffing or expertise in location at HQDFR. An assumption that the Contract Administrator could effectively supervise the myriad of facilities implications for almost 20 sites throughout Australia has proved to be unachievable.¹⁶⁰

¹⁵⁷ ‘Make good costs’ in this context refers to the cost of works that are required to be carried out by a lessee under a lease in order that the property is returned to the lessor, at the end of the lease, in the same condition as it was initially offered.

¹⁵⁸ Defence specified that there were 15 establishments for which the Previous Contractor held a lease, which would require novation to the Prime Contractor. There were also 59 leased vehicles used for promotional events and travel for deployable recruitment teams. Department of Defence, *Draft Disengagement Management Plan for the DFR Transition Phase*, July 2008, pp. 20–21.

¹⁵⁹ Department of Defence, *CA Notice CM 33/2008 – Direction to novate leases for: (A) Shop 28, Ground Floor, 55 Lake Street, Cairns; and (B) 143 Walker Street, Townsville*.

¹⁶⁰ Department of Defence, *Defence Force Recruiting Transition-In Report*, paragraph 12, pp. 10–11.

4.29 The lack of expertise available in DFR Branch was coupled with differences in the arrangements for DFR facilities—from Defence owned, Defence leased and leased by Manpower. In Table 5.2 (which includes payments to CMG between 1 February 2009 and 31 October 2009), there is an amount shown which relates to the lease arrangement for Level 17, 501 Swanston Street, Melbourne, that was also not included in the New DFR Contract.

Transition of the IT systems

4.30 Defence advised potential respondents to the RFT that: ‘Reliable and flexible IT platforms are central to the delivery of the New DFR’.¹⁶¹ Manpower’s transition out plan stated: ‘This [IT] is by far the most complex issue of the transition out’.¹⁶²

4.31 The issues affecting the transfer of the IT systems included :

- misalignment of the IT transition in and out plans between Manpower and CMG;
- insufficient documentation of the operation of the IT systems and services (software applications and network infrastructure), including known problems, for CMG to proceed with the IT transition;
- need to achieve security accreditation for CMG’s IT subcontractor (that is, meeting Defence’s security requirements);¹⁶³ and
- transfer of software licence(s) and third party contract arrangements.

¹⁶¹ Department of Defence, RFT No. NewDFR3/08, *Request for Tender, Part 2 – Information Provided to Requestors*, p. 25.

¹⁶² Manpower Services (Australia) Pty Ltd, *Defence Force Recruiting, Contract for the Provision of Recruiting Services, Transition Out Plan*, January 2007, paragraph 11. The Verification and Validation Report of 23 January 2009 of the Prime Contractor’s subcontractor refers to Defence’s requirement to apply a National Security Classification to personal information and the implications this had for the subcontractor’s IT approach. From the information available, it is not clear whether the previous contractor’s IT approach differed from the initial approach of the Prime Contractor’s IT subcontractor in regards to the security of personal information.

¹⁶³ EDS (Australia) Pty. Ltd was the Prime Contractor’s IT services subcontractor.

4.32 The New DFR Contract specified that CMG was responsible for providing, managing and maintaining all IT systems referred to in the Statement of Work.¹⁶⁴ However, Defence owned the bulk of the IT hardware and DFR systems.¹⁶⁵

4.33 As discussed in Chapter 3, Defence had imperfect knowledge of the operation of the DFR IT systems and was not adequately prepared for the New DFR procurement. There is evidence that during the tender process advice provided to tenderers by Defence was unclear regarding which party owned IT equipment used in DFR.

4.34 While Defence provided a number of documents about the IT system to the tenderers, it was difficult to find a clear and concise description of the operation of the DFR IT systems in a single document, including identifying the ownership of assets and explicitly defining the roles and responsibilities of the respective parties for the IT systems.

4.35 Defence informed the ANAO that it responded to the lack of documentation by, among other things, conducting workshops to enable knowledge transfer and introducing shadowing activities to provide exposure and experience. To gain necessary security accreditation, which was obtained in mid-2009, CMG's IT sub-contractor had to re-design its IT delivery solution.¹⁶⁶ In relation to the transfer of software licences, Defence indicated that this matter was finally resolved in July 2009.

Due diligence

4.36 Draft documentation prepared for the conduct of the transition phase for the New DFR Contract included a proposal for a range of due diligence activities to be undertaken related to IT systems during transition.¹⁶⁷ In the event, Defence relied instead on work undertaken as described in a scheduling

¹⁶⁴ *New DFR Recruiting Services Contract*, 2 July 2008, Contract Conditions, clause 11.3, p. 23.

¹⁶⁵ During the New DFR Contract, CMG's IT subcontractor owned a limited number of servers that supported DFR operations.

¹⁶⁶ CMG's IT sub-contractor's initial solution for delivering DFR IT services was based on a non-dedicated global switch environment which allows sharing of hardware, storages and remote monitoring by foreign staff. This solution did not meet Defence Security Authority's requirements for the delivery, servicing and storage of DFR data. However, this was not identified during the tender evaluation process and Defence did not advise CMG of this until after the New DFR Contract had been signed by the parties and CMG had commenced transition in.

¹⁶⁷ Department of Defence, Draft *Disengagement Management Plan for the DFR Transition Phase*, July 2008.

tool (the Transition Plan) and regular meetings to discuss, escalate and resolve issues.

New model: IT system changes

4.37 An additional complication during the transition period was the implementation of major changes to the recruitment IT systems connected to the trial of the New DFR service delivery model (see Chapter 1, paragraph 1.13). Defence considered: ‘The problem with the [Manpower] IT system during the initial transition period of July–September [2008] was that the changes to the new DFR were either not stable or even complete—with some changes being rolled out as late as September [2008].’¹⁶⁸ The changes included a hardware refresh for the DFR network and development of a software upgrade for Powerforce, the IT system that underpins all DFR recruiting operations.

4.38 In January 2009, CMG advised Defence that:

In relation to a ‘final solution’, we confirm that the process of identifying all non-performing, under-performing and non-compliant elements of the existing IT system is ongoing. The scope of works and activities involved in bringing the system into proper working order in accordance with the standards and specifications of the Statement of Work, and the estimated required timeframe for completion of those works and activities, has yet to be determined by [CMG’s IT sub-contractor]. [CMG’s IT sub-contractor] will be providing an updated Verification and Validation Report following Transition-In.¹⁶⁹

4.39 Defence informed the ANAO that the updated Verification and Validation Report was never provided. Defence stated that the issues related to the IT systems referred to in paragraph 4.38 were dealt with in the context of the commercial plea submitted by CMG to Defence in January 2009 (discussed in Chapter 5).

4.40 In earlier discussions between Defence, CMG and CMG’s subcontractor for the DFR IT systems, Defence advised CMG that:

As a threshold issue, there are some statements in the [IT subcontractors] briefing slides which might indicate that Defence has somehow caused or

¹⁶⁸ Department of Defence, *Defence Force Recruiting Transition-In Report*, 4 May 2009, p. 23.

¹⁶⁹ Chandler Macleod Group, *Interim Response to CA Notice 2/2009 – ICT Transition Approach*, 27 January 2009.

contributed to delays in the current [IT] transition process. For the record, Defence does not accept that it has caused or contributed to any such delay.¹⁷⁰

IT arrangement

4.41 As a result of the IT system issues during the transition period, CMG arranged to use Manpower's third party supplier for IT services to continue delivery of the DFR IT systems, while its own supplier developed a longer term approach.¹⁷¹ The arrangement continued until 30 June 2009, when CMG assumed full responsibility for the IT system.

4.42 Defence informed the ANAO that the main reasons for CMG using Manpower's third party supplier were that, at 31 January 2009, CMG's IT sub-contractor's data centres were not ready, the sub-contractor did not have necessary Telstra data lines and the sub-contractor's data centres did not have appropriate security accreditation.

4.43 The quotations in paragraphs 4.38 and 4.40 highlight the ongoing nature of the discussions between Defence and CMG about a number of issues with the IT systems during the transition period. From the correspondence, and related activity, it is apparent that achieving an alignment of the two contractors' IT transition plans, and their expectations, was central to the Transition Team's work.¹⁷²

4.44 It is not uncommon for service contracts to include provision for a formal due diligence period. For some current Defence service contracts, this period extends for six months after a new contractor commences delivering services and involves making sure that the cost schedule reflects actual requirements.¹⁷³ Such a due diligence period can also provide the opportunity to resolve other matters that may be known when a contract is signed but are not able to be resolved until after commencement of service provision.

¹⁷⁰ Department of Defence, *CA Notice 23/2008 New ICT Transition Approach*, 28 November 2008.

¹⁷¹ Datacom was Manpower's IT services subcontractor under the previous DFR contract.

¹⁷² Manpower expected transition out to commence on 1 November 2008, in accordance with their contract extension, however, CMG expected fully completed IT system documentation to be made available to it from early July 2008.

¹⁷³ Australian National Audit Office, *Garrison Support Services*, Audit Report No. 11, 2009–10, Canberra, p. 47, refers to the use of due diligence periods in garrison support services contracts.

4.45 If the New DFR Contract had contained a formal due diligence provision, it would have provided a process under which a number of the matters raised by CMG during transition and in CMG's January 2009 'without prejudice' submission (discussed in Chapter 5, paragraphs 5.14 to 5.33) could have been addressed. The New DFR Contract included a clause 27.13 which among other things stated:

the Contractor must provide all labour, supervision, on and off site overheads, goods, materials, spare parts, plant, equipment, facilities and consumables ("Work") which are required to enable the Contractor to comply with its Contract obligations or which are to reasonably inferred from the [Statement of Work] or otherwise from the Contract, notwithstanding that they are not expressly mentioned in the [Statement of Work] or otherwise in the Contract...

4.46 On a number of occasions in contract notices issued to CMG by Defence, reference was made to clause 27.13 in advising that Defence did not consider itself responsible for meeting certain facilities and marketing costs related to the delivery of DFR services. The ANAO suggests that referring to clause 27.13 in contract notices does not help resolve matters where the underlying data was not accurate or clear. Use of a formal due diligence period may assist in resolving differences where the original data and information available to tenderers may not have been accurate or complete.

4.47 A due diligence provision should be drafted in such a way that it does not allow a contractor to propose fundamental changes to the contract's pricing arrangements. This is best achieved by setting out clearly the matters to which the due diligence arrangements apply.¹⁷⁴

¹⁷⁴ An example of a due diligence provision is found in the Garrison Support Services contracts used by Defence. Those contracts provide that 'The Due Diligence period will extend for six months from the Commencement Date [of the contract] to enable validation of activity rates to ensure that price schedules reflect actual requirements and that quality targets and performance/compliance indicators are fair and reasonable.'

Recommendation No.4

4.48 The ANAO recommends that for any future DFR contract Defence include a formal due diligence period as part of the contract, where such an approach is consistent with the overall contract model, risk framework, and objectives for the contract.

Defence response

4.49 *Agreed.*

Post-transition status

4.50 A series of Contract Notices were issued by Defence to CMG after 1 February 2009 seeking advice about the status of achievement of CMG's transition in requirements.¹⁷⁵ In June 2009, Defence sought advice from CMG:

Transition In Status Update

- Submission of a Transition In Status Update as at 7 May 09 (or 29 May 09 where additional transition in tasks have been completed in between these two dates) ASAP, but in any case NLT 5pm AEST Tuesday 9 Jun 09. which details:
 - all Transition In tasks (as set out in the Transition In Plan) which have been completed; and
 - all Transition In tasks (as set out in the Transition In Plan) which are incomplete as at the date of the provision of the Transition In Status Update.¹⁷⁶

4.51 In February 2010, Defence informed the ANAO that no further activities specific to the transition occurred after June 2009. Defence indicated that, rather, any further requirements on CMG were considered within the context of discussions regarding the termination of the New DFR Contract.

Incomplete validation process

4.52 In order to manage the transfer of assets, services and documentation during the transition period, Defence developed 'Certificates of Acceptance and Validation' and 'Verification Checklists' documenting the transfer

¹⁷⁵ Department of Defence, CA Notice 4712009 - Transition In Status (4 June 2009); CA Notice 4612009 (20 May 09) - Transition In; and CA Notice 3712009 (30 April 2009).

¹⁷⁶ Department of Defence, CA Notice 47/2009 - Transition In Status (4 June 2009).

between the Manpower and CMG. The certificates covered the medical, psychology, training, marketing, IT and other national components of the transition.

4.53 Defence was reliant upon receiving sufficient information from Manpower during the transition period before certificates and checklists for the IT systems could be developed due to a lack of knowledge inside Defence of the operation of the recruitment IT Systems.

4.54 On 1 September 2009, eight months after the end of the transition period, Defence wrote to CMG advising that:

Defence attach for CMG's records, hardcopies of the Certificates of Acceptance and Validation and Verification Checklists documenting the transition of functions from Manpower to CMG. As CMG have previously been provided access to the Handover Documentation for the DFRs for the purpose of photocopying, Defence consider that CMG now have a copy of the all relevant transition documentation.¹⁷⁷

4.55 From a review of documentation held by Defence it is evident that the majority of checklists were completed in the period up to 31 January 2009. However, there are examples across a range of functions such as health and IT where sign-off did not occur until mid-2009.

Minimisation of any impact on recruitment performance

Lessons identified by Defence

4.56 In May 2009, Defence finalised a *Defence Force Recruiting Transition-In Report* that described the transition period process and activities, identified successes, difficulties and lessons learned and made two sets of recommendations aimed at: addressing Defence's preparation for outsourcing the DFR contract; and, better management of the New DFR Contract.

4.57 From Defence's perspective, the major success during the transition period was: 'minimal impact on the continuity of the operational efficiency of Defence Force Recruiting'.¹⁷⁸ Additionally, the transfer of a majority of the personnel from Manpower to CMG was identified as an important

¹⁷⁷ Department of Defence, Letter sent to the Prime Contractor, 1 September 2009.

¹⁷⁸ Department of Defence, *Defence Force Recruiting Transition-In Report*, paragraph 12, p. 8.

achievement that assisted with transferring business knowledge and continuing business operations.

4.58 The Transition-In Report presents a longer list of difficulties encountered during the transition period and lessons learned that are presented, in summary, in Table 4.2.

Table 4.2

Difficulties during the transition period and lessons learned

Milestone payments	<ul style="list-style-type: none"> • In the contract, there was a shortage of deliverable milestones during the transition period • Therefore, the Transition Team did not have recourse to financial penalties to ensure progress against the transition activities
Understanding of the contract	<ul style="list-style-type: none"> • There were frequent difficulties stemming from a lack of shared understanding of the contract
Timing	<ul style="list-style-type: none"> • The transition period overlapped with implementation of the New DFR model, which was not fully operational (for example, the CRMC and IT systems), and the two contractors' transition plans and expectations were not, initially, aligned • Further, the IT system transition was originally scheduled for completion in January 2009, the busiest time of the year for DFR
IT system performance	<ul style="list-style-type: none"> • The contractors had different expectations about the performance level of the extant IT systems
Defence personnel changes	<ul style="list-style-type: none"> • Defence faced additional challenges due to the transfer out of the DGDFR who undertook the tender process and the transfer in of a new DGDFR the day before contract signature and the majority of the ADF staff being rotated to new postings in Defence in the usual December–January cycle—that is in the final months of the transition between contractors.

Preparation for transition	<ul style="list-style-type: none"> • The lack of clearly recorded baseline information about DFR activities and assets made the transition period difficult in areas such as the IT systems, facilities management, security matters and GFE • The experience during transition highlighted the need for a change to DFR's approach to ensuring expertise and personnel requirements

Source: ANAO analysis.

4.59 Given that Defence did not undertake sufficient preparation for some aspects of the tender process, the difficulty in Table 4.2 described as 'understanding of the contract' was potentially foreseeable as Defence accepted a level of risk in going forward without being fully prepared for the transition period (see paragraphs 3.24 to 3.33). In February 2009, Defence described the contract negotiation and transition process as follows:

During [contract] negotiation CMG was provided with some verbal assurance that uncertainties arising from known information deficiencies would be addressed during the transition in period. Some changes in personnel within DFR and CMG after contract execution, and insufficient transfer of explicit or inherent knowledge after that time has flowed into decisions made during the transition in period.

A review of the process of the transition in period suggests that the intent of the assurance to CMG to address deficiencies was not followed, and early dialogue with the contractor was performed on a strict legal contractual basis. As such, the transition in period became difficult and led to a strained relationship in which any consideration of a cooperative solution was unlikely. There were many contributing factors to this unintended position.¹⁷⁹

4.60 The transition in report separately concluded that:

This facilities cost issue appears to be developing into a major running argument between the parties that has the potential to:

- permanently undermine good contract relations;
- adversely impact on operations;
- put at risk the viability of the tender evaluation; and

¹⁷⁹ Department of Defence, Minute, DGDFR/OUT/2009/35, *DFR response to CMG submission without prejudice*, 19 February 2009, paragraph 9, p. 3.

- potentially, to result in sub-standard DFR facilities in the future.¹⁸⁰

4.61 Chapter 5 discusses Defence's interim solution and final response to the facilities issues. Defence's approach to managing the facility-related issues was aimed at preserving the continued, unbroken delivery of DFR services.

4.62 The transition in report acknowledged that some of the difficulties encountered during the transition period could have been avoided altogether, or reduced in severity, if Defence had sought to establish a shared understanding of the New DFR Contract during the contract negotiation process. The report also highlighted the lack of sufficient expertise and an inadequate number of Defence personnel available to administer the New DFR Contract as contributing factors to the issues that arose during the transition period. The in-house resources and expertise available to Defence for the management of the New DFR Contract is discussed further in Chapter 5.

Australian Defence Force posting cycle

4.63 The ANAO has previously commented in audit reports on the desirability of retaining senior ADF personnel involved in delivering complex projects or procurements to ensure continuity and the retention of corporate knowledge.¹⁸¹ The ANAO is aware that the ADF posting cycle, now generally three years in length, rotates ADF personnel to another role, and potentially physical location, in January or July of a year where an ADF member is due for posting. The posting cycle is undertaken for career development purposes and/or to meet operational requirements.

4.64 Under the outsourced arrangements for ADF recruiting, overall management of individual Defence Force Recruiting Centres (DFRCs) is the contractor's responsibility. This approach is designed to: mitigate the risk of recruiting expertise being lost through the operation of the ADF posting cycle; and, contribute to continuity in the management and ongoing performance of the DFRCs.

¹⁸⁰ Department of Defence, *Defence Force Recruiting Transition-In Report*, p. 16.

¹⁸¹ See ANAO Audit Report No.41 2008–09 *The Super Seasprite*, for a discussion of the importance of planning to ensure skilled personnel are available, in sufficient numbers, to facilitate the smooth conduct of procurement and technical activities in support of complex, long term, major capital equipment procurements by Defence, paragraphs 1.16–1.23, pp. 62–65. Also, ANAO Audit Report No.32 2008–09 *Management of the Tendering Process for the Construction of the Joint Operation Headquarters*, discusses the importance of ensuring continuity of senior ADF staff for retaining corporate knowledge about a major procurement project, paragraphs 6.24–6.29, pp. 142–144.

4.65 In November 2007, when Defence extended the previous DFR contract and the New DFR procurement timeline (see Chapter 3) it was expected that the incumbent DGDFR would still be in that role until the new contract's transition period was completed.¹⁸² However, before the New DFR Contract was signed on 2 July 2008, a new DGDFR was appointed on 1 July 2008. The new DGDFR's appointment coincided with the start of Defence's management of the transition period between Manpower and CMG, which proved to be a significant management challenge.

4.66 In addition, CMG announced the appointment of a new Managing Director and Chief Executive Officer on 3 July 2008, the day after the New DFR was signed. As a consequence, both parties to the contract had changed their senior leadership between the tender submission, assessment and contract negotiation period, and the period during which CMG undertook transition towards contract management. This change in key personnel of both parties at this critical time potentially contributed to some of the contractual difficulties that arose during contract transition.

4.67 The ANAO notes that 19 months later, on 1 February 2010 (as a consequence of the promotion and transfer of the incumbent DGDFR) a new DGDFR was appointed to head DFR. This appointment occurred on the same day as Manpower once again took over the delivery of recruitment services from CMG under a sole sourced two year interim contract.

Recommendation No.5

4.68 In view of the benefits from continuity in the role of Director-General, Defence Force Recruiting Branch during critical stages in the ongoing management of Defence Force recruiting contracts, the ANAO recommends that Defence plans its rotation of senior ADF personnel through this position to minimise disruption at critical stages of the contracting cycle.

Defence response

4.69 *Agreed with qualification.* The current Director General of DFR was appointed for a three-year posting in February 2010. This will provide

¹⁸² Department of Defence, Minute to Head Personnel Executive, DGDFR/2007/OUT/429, *Extension of the Contract for Provision of Recruiting Services to the ADF*, 5 November 2007. The previous DGDFR's term of appointment was from 25 July 2005–30 June 2008.

continuity in the position throughout the planning, procurement, and transition stages for DFR 2012.

4.70 Defence agrees that continuity in senior ADF positions during critical stages of the contracting cycle is desirable. Ultimately, the timeframes for senior ADF postings should deliver utility for the organisation, within the overriding context of meeting operational imperatives and priorities.

4.71 Such imperatives can arise without warning and require rapid out-of-cycle posting action to deliver operational capability. The early posting of the former DGDFR to Border Protection Command, soon after transition from CMG to Manpower, was an example of this type of situation.

Target achievement during transition

4.72 As previously discussed in Chapter 1, the Candidate Relationship Management Centre (CRMC) was central to the implementation of the New DFR model and Defence intended that the reform would be fully operational before the transition period commenced. However, during the transition period, Defence advised the then Minister for Defence, Science and Personnel in September 2008 that a delay in establishing a fully operational CRMC: ‘combined with modifications to the recruiting process have resulted in a temporary “blockage” in the recruiting pipeline. As a result, candidates have not been processed efficiently which is now showing negative impacts on the latest recruiting achievement figures.’¹⁸³ Defence allocated additional ADF DFR resources to support the CRMC’s activities and worked with both Manpower and CMG to identify a longer term approach to managing the CRMC.

4.73 On 6 October 2008, Defence provided the then Minister for Defence, Science and Personnel with a report on ADF workforce and personnel issues. Included in the advice was a statement describing recruitment performance during the first two months of the transition period:

Recruitment achievement against a year-to-date comparison is lower than the same period last year but, as many of the recruiting campaigns are seasonal, is not necessarily a predictor of full-year results. That said, recruiting

¹⁸³ Department of Defence, *Ministerial Submission for Noting—Brief on the New DFR Recruiting Model/CRMC and Recruiting Delays*, DGDFR/OUT/2008/802, paragraph 3, p. 1.

performance is receiving close scrutiny and strategies are being put in place to better manage the transition of the Defence Force Recruiting contract.¹⁸⁴

4.74 A later briefing to the then Minister for Defence, Science and Personnel, on 10 October 2008, on the subject of the DFR contract's transition period, did not comment further on recruiting performance.¹⁸⁵ In Chapter 5, Figure 5.1 reports on monthly recruitment achievement from July 2008 to January 2010 and shows that target achievement ranged from 68 per cent to 80 per cent during the transition period (July 2008 to January 2009). This compares to previous performance over a similar period from July 2007 to January 2008 during which target achievement ranged from 76 per cent to 90 per cent.

Commercial viability

4.75 During the ITR evaluation (see Chapter 3), a due diligence process for the ITR respondents' financial and corporate viability was conducted. The overall assessment for CMG was that the company appeared to be of low financial viability risk, with strong revenue and profitability as well as having strong net assets and a satisfactory liquidity position.¹⁸⁶

4.76 As discussed in Chapter 2, footnote 60, during 2008 the effect of deteriorating global financial conditions was affecting many sectors in the Australian economy. After the New DFR Contract was signed in July 2008, CMG advised the DGDFR in August 2008 of: 'a significant investment in the company by a private investment bank as part of a rights issue ... would not affect the Recruiting Services contract'.¹⁸⁷ As a result of adverse commentary in the media suggesting that CMG was experiencing financial difficulty, Defence advised the then Minister for Defence, Science and Personnel, in September 2008, that financial advisors from the New DFR procurement's Project Advisor had conducted a further review of CMG's financial position.¹⁸⁸

¹⁸⁴ Chief of the Defence Force, *Service Chief Quarterly Report on Workforce and Personnel Issues*, CDF/OUT/2008/827, 6 October 2008, Attachment E.

¹⁸⁵ Department of Defence, *Ministerial Submission for Noting—Defence Force Recruiting Contract Transition Update*, DGDFR/OUT/2008/826.

¹⁸⁶ Department of Defence, *ITR Evaluation Report*, December 2007, pp. 30–42.

¹⁸⁷ Department of Defence, *ADF Recruiting Services Contractor Short Term Financial Viability*, HPC/OUT/2008/13. The Prime Contractor sought to raise capital of around \$25.7 million to reduce debt and provide working capital by offering shareholders to opportunity to buy additional shares—a rights issue.

¹⁸⁸ KPMG conducted the financial review of the Prime Contractor and is referred to as the Project Advisor in this report.

4.77 The financial assessment concluded that:

the overall financial viability risk rating has increased the risk level in the short term from low to medium. The assessment identified that the organisation appears to be financially sound in the medium and long term, due to its large net asset position, increasing revenues and historical profitability.¹⁸⁹

4.78 During the transition period, the then Minister for Defence, Science and Personnel was regularly informed by Defence of the progress of CMG's rights issue and Defence also regularly sought advice from its Legal Advisor for the New DFR procurement.

4.79 CMG's financial position and commercial viability were monitored by Defence during the remainder of the contract. Additionally, Defence developed a *Recruiting Contingency Plan* in December 2008 that identified critical timing points and discussed four options:

1. Provide financial assistance to CMG to enable them to trade out of difficulty and continue to operate the business;
2. Roll back to the current contractor [Manpower];
3. Re-tender the services; or
4. Defence takes back the provision of recruiting services.¹⁹⁰

4.80 However, after meeting with CMG on 1 December 2008 to discuss the company's financial viability, Defence was sufficiently reassured to continue with the transition activities as planned. Both parties considered there was the potential for reputational impact, if the contract became unworkable. Defence was also cognisant of the risk of legal challenge by the unsuccessful tenderers if substantial amendments were made to the New DFR Contract, so soon after the procurement process was completed, in order to provide financial assistance to CMG.¹⁹¹

4.81 On 11 December 2008, CMG initiated a meeting with Defence to discuss a commercial proposal to vary the New DFR Contract to address the:

¹⁸⁹ Department of Defence, *ADF Recruiting Services Contractor Short Term Financial Viability*, HPC/OUT/2008/13.

¹⁹⁰ Department of Defence, *Recruiting Contingency Plan*, 5 December 2008.

¹⁹¹ A legal challenge was possible if the contract could be said to be substantially different from that described in the original tender and on which basis it was awarded to the Prime Contractor.

‘unanticipated costs and liabilities associated with facilities’,¹⁹² which were identified by CMG during the transition period as being of serious concern.

4.82 The amount of the increase sought by CMG was \$140 000 per month for the life of the contract (\$8.4 million over the term of the five year contract.) CMG advised Defence that if the proposal was not accepted, and the additional costs and liabilities for facilities were incurred: ‘the continued performance of the Contract is likely to become commercially unviable for CMG.’¹⁹³

4.83 Defence requested additional information about the basis for the submission. On 14 January 2009, Defence met with CMG to discuss a draft proposal, which was finalised by CMG and sent to Defence on 30 January 2009 as a more detailed, wide-ranging, ‘Without Prejudice’ Submission for consideration.

4.84 The outcome of Defence’s consideration of CMG’s formal submission, referred to by Defence and in this report as ‘the commercial plea’, is the subject of Chapter 5. Defence’s view, after receiving the commercial plea, was that:

some complications [during the transition period] were exacerbated by Defence’s management of the activity, including a number of the claims made in CMG’s submission which could have been resolved earlier had Defence addressed them when they were first raised during Transition.¹⁹⁴

4.85 At the contractual end of the transition period, the relationship between Defence and CMG was under significant pressure and deteriorated further in 2009. Defence’s primary concern was the continued operation of the contract and maintenance of DFR activity at the required levels.

¹⁹² Mr Ian Bassar, Chief Executive Officer, Chandler Macleod, *Briefing Paper from Chandler Macleod Group to Phil Minns, Deputy Secretary*, 11 December 2008.

¹⁹³ Mr Ian Bassar, Chief Executive Officer, Chandler Macleod, *Briefing Paper from Chandler Macleod Group to Phil Minns, Deputy Secretary*, 11 December 2008.

¹⁹⁴ Department of Defence, *DEPSEC PSP Brief, DFR Response to CMG Submission Without Prejudice*, DGD/FR/OUT/2009/35, 19 February 2009, Annex A.1, Response to Claim Number 36, p. 27.

5. Termination of the Recruitment Services Contract

This chapter examines the commercial plea by the contractor and the subsequent events, in particular the steps undertaken by Defence to resolve the matters and ensure the ongoing Defence recruitment action. The chapter also examines matters regarding the operation of recruiting since 1 February 2009 and the mutual termination of the New DFR Contract with CMG.

Introduction

5.1 As noted in Chapter 4, on 30 January 2009, at the conclusion of the transition in period for the New DFR Contract, CMG submitted to Defence a detailed, wide-ranging, 'Without Prejudice' Submission to address the: 'unanticipated costs and liabilities associated with facilities',¹⁹⁵ which were identified by CMG during the transition period as being of serious concern. This submission was referred to by Defence as 'the commercial plea'.

5.2 Following Defence's formal response to CMG's submission on 1 May 2009, discussions took place between the two parties regarding the possible termination of the New DFR Contract. In the event, a termination deed between CMG and Defence was signed on 2 October 2009, which the parties subsequently agreed to vary through an amending deed signed on 11 December 2009.

5.3 As part of its examination of Defence's management of these matters, the ANAO considered:

- whether Defence sought appropriate legal, financial and commercial advice regarding the actions that it should take in responding to CMG's without prejudice submission and in developing the Termination Deed, and whether Defence had appropriate resources in place for the management of the New DFR Contract;

¹⁹⁵ Mr Ian Bassar, Chief Executive Officer, Chandler Macleod, *Briefing Paper from Chandler Macleod Group to Phil Minns, Deputy Secretary*, 11 December 2008.

- whether Defence appropriately analysed the implications of the Commonwealth Procurement Guidelines;¹⁹⁶
- performance of key recruitment services since 1 February 2009;
- the financial implications of Defence's response to CMG's without prejudice submission and the Termination Deed; and
- the payments or commitments made by Defence to CMG since 1 February 2009 arising from the New DFR Contract.

5.4 As discussed in Chapter 1, paragraphs 1.20 to 1.24, following Defence's advice to the ANAO during the early stages of the audit about unresolved commercial matters between Defence and CMG, the audit's scope and criteria were adjusted to take account of the changed circumstances. The audit examined the contractual difficulties with CMG, including any operational impact, and the resolution of those matters to the extent that had occurred by the end of the audit. The audit generally did not examine matters that occurred after the date of signature of the termination deed, as amended, including the process undertaken to put in place alternative recruitment services.

Advice and assistance obtained by Defence relating to its management of the contract with CMG

5.5 Throughout 2008–09 and in 2009–10, Defence sought considerable advice and assistance from a range of external professional advisers relating to the contract with CMG for recruitment services. This advice related to: the transition in of CMG and the transition out of Manpower; consideration of the without prejudice submission by CMG; the operation of recruiting services (particularly since 1 February 2009); and the development of the Termination Deed. The key advisers that were involved throughout this period, the matters on which they provided advice and the related costs, are set out in Table 5.1.

¹⁹⁶ Department of Finance and Deregulation *Commonwealth Procurement Guidelines* (Financial Management Guideline No. 1).

Table 5.1**Cost of consultants used by Defence following the signing of the contract of the contract with CMG on 2 July 2008**

Supplier	Description of services	2008-09 (\$m)	2009-10 ^B (\$m)	Total (\$m)
Cordelta	Transition adviser, forensic accountant, ongoing contract issues, termination and re-tender	0.785	0.483	1.268
Clayton Utz	Contract legal advice	0.444	0.738	1.182
Clayton Utz	Local area marketing contract advice ^A	0.128	-	0.128
KPMG	Financial viability	0.075	0.013	0.088
Info Logic/Paxus	IT consultancy services during transition and advisory role on ongoing contract issues	0.102	0.084	0.186
Golden Olive Company	Transition Manager (CMG transition in and Manpower transition out)	0.114	-	0.114
Deloitte	Probity	0.010	0.010	0.020
Australian Government Solicitor	Legal advice	0.017	0.038	0.055
Total^B		1.675	1.366	3.041

Notes: (A) Defence advised that this amount includes other activities (for example, other marketing and sponsorship contracts) and the amounts are not separately itemised on the contract.

(B) Costs relate to the first six months of 2009–10.

Source: Defence.

5.6 As Table 5.1 shows, in 2008–09 the total cost of external advisers was nearly \$1.7 million, with nearly \$1.4 million further being paid to these providers in the six months to 31 December 2009. In addition to the amounts set out in Table 5.1, Defence incurred further costs for external advisers in relation to the interim contract tender process and the transition to the interim contract.¹⁹⁷

5.7 Given the issues confronting Defence during this period, the approach taken by Defence in seeking advice was prudent. Nevertheless, the breadth of matters on which Defence needed to engage external assistance was

¹⁹⁷ The tender for the interim contract was not examined as part of this audit. The audit focused on matters up until the execution of the Termination Deed, as amended, for the New DFR contract.

substantial. Chapters 3 and 4 include discussion of the key roles that external advisers had taken in the tender assessment for the New DFR Contract and the transition in of CMG (as well as the transition out of Manpower).

5.8 In discussing the establishment and sustainment of contract capability, the joint Finance/ANAO Better Practice Guide *Developing and Managing Contracts* refers to a number of matters important in having effective contract management capability, including:

- the necessary level of senior management commitment and support;
- staff who exercise procurement delegations with experience and knowledge commensurate with the size, nature and complexity of the contracting activities on which they make decisions;
- sufficient time and resources to properly manage the contract, including access to specialist skills where needed; and
- individual contract managers with a level of knowledge, skills and experience commensurate with their contracting responsibilities.¹⁹⁸

5.9 Defence has relied on an external provider, Cordelta, for important elements of its ongoing contract management. In addition, Defence employed a separate consultant¹⁹⁹ to manage the transition in of CMG and transition out of Manpower for the New DFR Contract and used another consultant to manage the transition out of CMG and transition in of Manpower as a result of the agreement to terminate that contract (subject to the condition precedent for the Termination Deed being met). There is a substantial risk inherent in such an approach to contract management in that Defence itself may not have sufficient corporate knowledge related to its ongoing dealings with the relevant provider of outsourced recruitment services.

5.10 Defence informed the ANAO that its use of contractors was a legitimate strategy to address an identified risk during key stages of the contract negotiations, transition and management. The ANAO accepts that it is prudent to use expert contractors for certain matters.

¹⁹⁸ Department of Finance and Administration and Australian National Audit Office (2007) *Developing and Managing Contracts*, Better Practice Guide, p. 67.

¹⁹⁹ Golden Olive Company.

5.11 To effectively use an external service provider to deliver DFR services, it is important that Defence also invest sufficiently in its own staff and resources to make sure that it has sufficient in-house expertise to undertake the contract management role, including any transition in or out arrangements. In the case of the first two DFR contracts, both the initial contract with Manpower and the New DFR Contract with CMG, it is not clear that Defence has maintained sufficient in-house capability for the ongoing management of the contract. The issues that arose during the tender process regarding underlying data relating to leasing and IT arrangements, as well as the pricing provisions in the New DFR Contract, emphasise the need for Defence to be able to retain a core level of knowledge and understanding.

Recommendation No.6

5.12 As part of any decision on Defence's future approach to Defence Force Recruiting, the ANAO recommends that Defence reviews the level of in-house capability it requires to effectively undertake the ongoing contract management responsibilities associated with any outsourced option that may be adopted.

Defence response

5.13 *Agreed.* This recommendation has been referred to the DFR 2012 project team. The level of ongoing, in-house contract management capability DFR requires will be reviewed as part of the DFR 2012 project development.

CMG's 'without prejudice' submission – the commercial plea

5.14 To provide an appropriate basis for considering CMG's concerns regarding the operation of the New DFR Contract, Defence informed the ANAO that it suggested to CMG that it prepare and submit to Defence a 'commercial plea' outlining its concerns, the basis for them and the remedies it was seeking. CMG's 'without prejudice' submission of 30 January 2009 stated that it wished to vary the pricing provisions within the New DFR Contract on the basis that:

- (a) it [the contract] does not reflect the commercial arrangement understood by the parties upon signing; and (b) the business and operations of DFR [Defence Force Recruiting], including all costs, assets and liabilities to be assumed by

CMG, were not able to be understood by CMG prior to entering into the Contract.²⁰⁰

5.15 In this submission, CMG expanded on its position by putting forward a number of particular claims:

- that CMG understood that the amount of \$405 million was the total price payable under the contract over five years, including all known and unknown reimbursable costs, this figure having been included in the previous Minister for Defence Science and Personnel's announcement of the contract between CMG and Defence;²⁰¹
- from CMG's reading of the contract, if it met all targets and expectations of Defence, the total maximum amount that it would be able to receive was \$307 million (\$98 million less than the amount referred to in the then Minister's announcement);
- that the contract did not contain a standard provision for reimbursement of costs incurred in providing DFR services;
- that, during transition in, CMG became aware of certain costs and liabilities involved in the operation of DFR that it had not included in its pricing as they were unknown to CMG, or to the extent they were anticipated, they were understood by CMG to be the responsibility of Defence or Manpower.

5.16 CMG's 'without prejudice' submission also included examples of additional costs and liabilities that CMG claims it discovered during transition in. Particular matters referred to were:

- existing 'make good' obligations under leases that were transferred to CMG under the contract;
- the costs associated with relocation of DFR premises upon the expiry of leases transferred to CMG under the contract, including the cost of fitting out new premises;
- the costs associated with additional facilities required to conduct medical testing and psychometric assessment;

²⁰⁰ Submission attached to letter from the Prime Contractor to Defence of 30 January 2009, p. 1.

²⁰¹ Warren Snowdon (Minister for Defence Science and Personnel) 2008, *New Contract to Support ADF Recruiting*, media release 085/2008, 2 July 2008.

- the costs associated with upgrading existing premises, facilities and IT infrastructure to ensure compliance with applicable security standards;
- the costs associated with rectifying existing IT infrastructure which CMG claimed was under-performing;
- the costs associated with compliance data management obligations; and
- the cost of obtaining insurance cover for GFE and the unknown costs of maintaining GFE.

5.17 CMG also claimed that, during the contract negotiation process, Defence reduced the size of the debt finance facility in the contract from \$20 million to \$5 million, as well as requiring that the facility be applied to 'an upfront liability to the Previous Contractor [Manpower]' and thus not be available for any other purpose. In addition, CMG claimed that during the tender and negotiation stages the provisions of all third-party contracts which CMG would assume under the contract were not accurately disclosed.

Consideration of CMG's 'without prejudice' submission

5.18 On 19 February 2009, DFR submitted a paper to the Deputy Secretary People Strategies and Policy (DEPSEC PSP) which indicated that, in Defence's view, the majority of claims raised by CMG in what Defence called its 'commercial plea' submission were unsubstantiated, or easily clarified through Defence evidence. However, the paper indicated that a number of the claims raised by CMG were valid and these related to:

- the cost of bringing facility and information technology security up to standard;
- the cost of bringing information technology performance up to baseline standards;
- the cost of establishing DFR Centre premises in Canberra and Albury; and
- possible 'make good' costs incurred at the cessation of particular leases.

5.19 The paper indicated that further research was required to ascertain the exact costs to be incurred in addressing valid claims. The paper also notes that there may be options to request rectification by Manpower. The paper proposed that a small contract negotiating team be established to finalise the cost of those items that Defence should meet and develop any necessary contract amendment.

5.20 An attachment to the paper explained Defence's view on the difference between CMG's calculation of the maximum amount it would receive over the life of the contract (\$307 million) and the contract value announced by Defence (up to \$405 million).²⁰² The attachment also noted that: 'legal advice confirmed that it is not standard practice to include a general reimbursable provision in a contract unless clearly agreed and documented by both parties.'²⁰³ Further attachments to the paper included analysis of a number of claims included in CMG's 'without prejudice' submission prepared by the firm which managed the tender assessment for Defence, and advice related to IT matters provided by Defence's legal advisers when the issues first arose during transition.

5.21 It is not unusual in respect of contracts of the size of the New DFR Contract for adjustments to the contract (and therefore related payments) to be necessary as the parties progress through the early stages of the contract. In some cases formal periods of due diligence are established to allow both an agency and the contractor to raise matters for consideration that were not evident at the time of contract signature, or during the tender (see discussion at paragraphs 4.25 to 4.45).

5.22 In these circumstances, a key consideration for agencies is that any adjustments made as a result of due diligence do not serve to change the value for money basis on which the original tender assessment decision was reached. Based on the examination of the tender process in Chapter 3 and the transition in Chapter 4, there is evidence that certain of the matters raised by CMG (for example, IT systems) were identified as weaknesses at the time of tender issue and assessment, as well as prior to CMG becoming responsible for delivering the recruitment services. This suggests that there are certain matters on which Defence could have agreed to amend the contract and not change the value for money basis on which the tender decision was made. Defence informed the ANAO that this, indeed, was the approach which it adopted, seeking additional information from CMG to enable an informed consideration of the appropriateness of any suggested contract variations.

²⁰² The difference of \$98 million was explained by amounts not taken into account in the Prime Contractor's calculation (\$16 million for reimbursable costs, \$6 million related to debt financing facility repayments, additional fixed fee payments in 2013–14 of \$14 million, additional per head fee in 2013–14 of \$27 million, additional incentive fee payments in 2013–14 of \$1 million, and GST of \$37 million) and an overestimate of the per head fee in 2008–09 (\$3 million).

²⁰³ Brief of 19 February 2009 provided to the Deputy Secretary People Strategies and Policies by the Director-General Defence Force Recruiting, Annex A.1, p. 2.

5.23 Nevertheless, the comments made by CMG regarding its understanding of the pricing of the contract, the need for a 'standard clause' for the reimbursement of costs and its approach to various costs associated with leases, suggest that CMG may have been seeking amendments to the contract to increase the revenue available to it under the New DFR Contract. As discussed in Chapter 2 (see paragraphs 2.13 and 2.14), in its tender process, Defence had sought to control its DFR budget and provide an incentive for potential contractors to achieve target levels of recruitment. Part of the response required from tenderers was for each tenderer to decide its pricing and how much revenue it wished to put at risk. Of the three tenderers, the pricing response from CMG put the highest proportion of its revenue at risk and also set for itself the highest level of implicit performance (see Chapter 3, paragraph 3.57).

5.24 As discussed in Chapters 3 and 4, as part of the tender process, and during the transition in period, Defence had organised for its Project Adviser, to undertake assessments of CMG's financial viability. On 13 March 2009, the Financial Adviser provided Defence with an updated financial viability risk assessment based on CMG's financial statements for the six months to 31 December 2008. The Financial Adviser stated:

Overall, CMG's financial viability risk rating remains at Moderate. While the company's liquidity position has improved between 30 June and 31 December 2008, the company's cash position remains weak and profitability has continued to deteriorate.²⁰⁴

5.25 In its letter of 13 March 2009, the Financial Adviser recommended that Defence seek from CMG a detailed costing and explanation of each item in its commercial plea, as well as additional information on how CMG planned to ensure future viability (including details on strategic plans, forward budgets, debt agreements, associated debt covenants and contingency funding arrangements). The Financial Adviser indicated that it understood that the department had been unable to obtain this information up to that point; however, it considered that such information was required to fully assess both CMG's claim veracity and the company's future viability risk.²⁰⁵

²⁰⁴ Letter from KPMG to Director Management and Standards, Defence Force Recruiting, Department of Defence, 13 March 2009.

²⁰⁵ Defence informed the ANAO that it issued a contract notice (13/2009) to CMG on 3 March 2009 seeking budget information to which CMG responded declining to provide such information.

5.26 Defence wrote to CMG on 25 March 2009 indicating that it had not thus far responded to the company's commercial plea because it was seeking further costing information, in particular the costs of:

- bringing DFR facilities and information technology security up to required standards;
- bringing current IT systems' performance up to a standard which will provide the required functionality to perform the services in a reliable, ongoing manner;
- establishing DFR Centre premises in Canberra and Albury; and
- 'making good' the current facilities leases for those existing DFR premises that were subject to a reimbursable cost arrangement with Manpower.

5.27 In the letter of 25 March 2009, Defence indicated that it was committed to ensuring a fair process in consideration of CMG's claims in its commercial plea.

Defence response to CMG's 'without prejudice' submission—the commercial plea

5.28 In a letter of 17 April 2009 to CMG, Defence provided a table presenting a forecast schedule of the potential cost of the New DFR Contract to Defence over the contract term (five years), should CMG be entitled to be paid the maximum amounts potentially payable under the contract and assuming specific recruitment targets to be set by Defence. This advice was provided to assist CMG to understand how Defence viewed the potential value of the contract. The ANAO notes that Defence calculated the potential value of the contract assuming that the recruitment target for each of the five years covered by the New DFR Contract would be 10 500 and that CMG achieved 100 per cent of the target.

5.29 It is important to recognise that, under the New DFR Contract, CMG's revenue was heavily dependent on the per head recruitment fee payable, and that the target levels of recruitment (for the three Services and for particular sub-groups) are set by Defence (see Chapter 1, paragraph 1.6). Reductions in the target levels of recruitment would reduce CMG's potential revenues. In addition under the current DFR model, as described in paragraphs 2.4 and 2.5, in Chapter 2, Defence also plays a role at certain key stages within the actual recruitment process such that the achievement of individual recruitment outcomes for candidates involves both the recruitment prime contractor's staff

and ADF personnel, as well as the Defence Service Centre (call centre) operated by DSG in Cooma. However, Defence noted that neither of these issues were factors identified by CMG in its 'without prejudice' submission.

5.30 Defence responded to CMG's commercial plea in a letter of 1 May 2009 in which it indicated that it was willing to propose to vary the New DFR Contract to address the following broad areas, subject to verification of relevant costs:²⁰⁶

- remediation of existing facility and information technology (IT) security;
- rectification of IT performance;
- fit-out costs for establishing DFRC premises in Canberra and Albury;
- adjustments to cover lease costs for DFRC premises in Brisbane and Albury; and
- possible 'make good' costs incurred with the exception of Brisbane, Parramatta and Maroochydore DFRCs.²⁰⁷

5.31 Defence stated that its intention in pursuing these activities and proposing to vary the New DFR Contract in this way was to enable both parties to move forward so that CMG can deliver the contracted services. Defence also referred to its willingness to act on a number of other matters in order to improve recruitment performance (the provision of additional ADF personnel and improving performance of the Defence Service Centre).

5.32 Defence indicated that unless CMG was able to demonstrate that Defence's view of the revenue model, as expressed in its letter of 17 April 2009, was incorrect it did not propose to change the approach to remunerating CMG.

5.33 In advice of 1 May 2009, the Australian Government Solicitor (AGS), which had been advising Defence regarding the development of its response to the commercial plea, stated:

²⁰⁶ Letter from the Deputy Secretary, People Strategies and Policy, Department of Defence to the Managing Director of the Prime Contractor, 1 May 2009.

²⁰⁷ To build a positive client/provider relationship, Defence proposed to meet the liability for reasonable 'make good' costs under the leases for those premises that were subject to a reimbursable cost arrangement with the Previous Contractor. Three premises—Brisbane, Parramatta and Maroochydore—were excluded as the contract with the Previous Contractor provided for Defence to meet 'make good' costs for 11 premises, but not for these three premises.

In our view, the costs identified by the Commonwealth as part of its consideration of the commercial plea from CMG as being capable of negotiation; namely, Information Technology (IT) and facility security remediation, rectification of IT 'underperformance', premises fit-out costs for establishing DFRC premises in Canberra and Albury, and leasing expenses (increased lease costs and "make good costs"), are not, based on the information provided to us, matters which, if agreed by the Commonwealth, would be likely to undermine the Commonwealth's original value for money decision to enter into the Contract with CMG.

In particular, at least the majority of the costs associated with these matters appear likely to have applied to the provision of DFR services under the Contract regardless of who the successful provider was.

In respect of the broader aspects of CMG's commercial plea, such as the request for the inclusion of contractual mechanisms providing for general reimbursement of costs, we consider that the inclusion of such changes would have the potential to significantly undermine the Commonwealth's original value for money selection of CMG under the RFT [Request for Tender] process.²⁰⁸

Operation of DFR by CMG from February 2009

5.34 In accordance with the New DFR Contract, CMG was responsible for delivering recruitment services from 1 February 2009. In relation to the period from 1 February to 30 June 2009, and from 1 July 2009 to 31 October 2009 Defence paid CMG \$24 million, and \$14 million respectively.

²⁰⁸ Letter of 1 May 2009 from the Chief General Counsel and the Senior Executive Lawyer, Australian Government Solicitor, to Defence, p. 1.

Table 5.2**Payments by Defence to CMG from 1 February 2009**

Description	1 February to 30 June 2009 (\$ million)	1 July to 31 October 2009 (\$ million)
Fixed fee	6.721	5.459
Per head recruitment fee	15.689	7.680
Per head incentive payment	0.194	-0.006 ^B
Reimbursables ^A	0.591	0.682
<i>Total payable under original New DFR Contract as signed 2 July 2008</i>	<i>23.195</i>	<i>13.815</i>
Government furnished equipment (GFE) ^C	0.126	0.002
Additional funding for CRMC staff ^D	0.399	nil
Additional funding for rent of Level 17, Melbourne ^D	0.070	0.043
Additional funding for the Specialist Recruiting Team (SRT) ^D	0.207	0.113
Total	23.997	13.973

Notes: (A) These are amounts such as candidate travel and other recruitment costs which were provided for under the New DFR Contract with CMG as signed on 2 July 2008.

(B) This is an adjustment to the previous year's payments.

(C) Maintenance of GFE and insurance of GFE was the responsibility of CMG under the contract. These amounts were for new or replacement GFE in the various DFRs where necessary. This amount was not provided for by Defence in the original approved estimate of up to \$405 million for the cost of the New DFR Contract over its five year term.

(D) These amounts were payable under a contract amendment of 12 May 2009. The additional funding for CRMC and SRT and was initially until 30 June 2009, and the Level 17 rent until 28 May 2009. Later amendments extended the period for which Defence would assist with SRT and Level 17 rent.

Source: Department of Defence.

5.35 Specialist Recruitment Teams (SRTs) were developed as part of the New DFR model to focus on recruiting engineering officers, health professionals and technical trades people. The SRT initiative was being piloted when the New DFR tender was released and was not included in the New DFR Contract. Defence intended to provide the additional funding for the SRT initiative by way of an amendment to the New DFR Contract.

5.36 Based on the design of the New DFR Contract, Defence was always required to meet the cost of replacement GFE (generally office furniture) where the existing GFE is unrepairable, although Defence had not included provision for this cost in the department's original estimate of the total cost of the New DFR arrangements.

Recruiting performance

5.37 Figure 5.1 sets out the recruiting performance in the period from July 2008. There are various ways in which Defence monitors ADF recruitment for different purposes. The data presented in Figure 5.1 is consistent with the previous recruitment contract with Manpower and the New DFR Contract with CMG and the way in which Defence monitors the performance of the recruitment prime contractors.

5.38 The DFR level of achievement against its overall target for recruiting for the ADF in the period since February 2009 (when CMG took over) has varied between 74 per cent and 97 per cent on a monthly basis. This reflects a general upward trend in the percentage of target recruitment achieved over the period concerned. However, it should be noted that, chiefly because of improved retention of existing ADF members, the target set by Defence decreased from 10 393 in 2008–09 to 9280 in 2009–10, a reduction of 10.7 per cent.

5.39 Performance of the recruitment process in the first part of 2009, in terms of achievement against target, was not at a level that was anticipated by Defence during the tender process. Factors affecting this situation were the increased level of interest in joining the ADF during 2009, and the resultant difficulties in managing the recruitment pipeline. The recruitment target for the seven months to 31 January 2010 was 7.3 per cent less than the target for the comparable period 12 months earlier,²⁰⁹ although the actual number of enlistments (excluding Gap Year entry) grew by 558 in the more recent period.

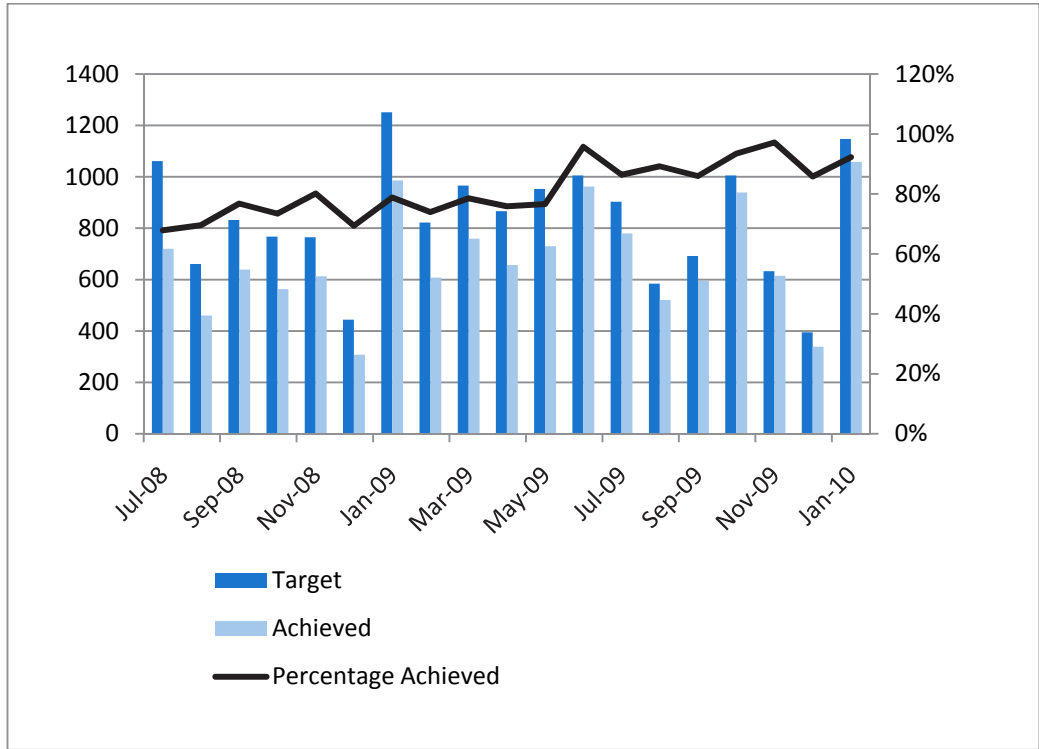
5.40 The level of achievement in all months that CMG was the recruitment prime contractor (that is, February 2009 to January 2010) was less than the KPI of 100 per cent that was included in the New DFR Contract. DFR performance against this indicator over a longer period of time (covering both the previous

²⁰⁹ The recruitment target for the seven month period in 2008–09 was 5 781 and for the same period in 2009–10 was 5359.

recruitment contract with Manpower and the New DFR Contract with CMG) is outlined in Figure 2.2 in Chapter 2. However, while performance varied over time, there is no evidence that during either contract that 100 per cent of the recruitment target was met in a particular period.

Figure 5.1

Recruitment into the ADF through Defence Force Recruiting (except Gap Year entry): target recruitment, achieved recruitment and percentage of target achieved – July 2008 to January 2010



Note: Defence informed the ANAO that these figures are sourced from internal DFR data which informs ADF workforce planning data. Workforce planning data is the official data utilised to measure ADF recruitment achievement. This data may not align with released ADF workforce planning figures but the ANAO has used this data for this analysis because it is the data used for assessing performance of the DFR contractor.

Source: Defence.

DFR actions to support recruiting performance

5.41 An issue that arose early in the New DFR contract with CMG related to the level of recruitment enquiries being received. The number of enquiries from prospective recruits was at least 20 per cent higher in early 2009 compared to this period in previous years and stayed relatively high in the following months.

5.42 Under the DFR model, initial telephone enquiries from prospective recruits are handled by Defence Service Centre (DSC), which is staffed and operated by the Defence Support Group (DSG). Given the important role that the DSC plays at the front end of the recruitment process, and the impact this has on the overall recruitment process (see Figure 1.1 and paragraph 1.6, Chapter 1), it is crucial that the DSC is in a position to properly facilitate the initial contact from prospective recruits. However, in March 2009, in the course of a process DFR Branch was undertaking to put in place a Service Level Agreement (SLA) with the DSC, DSG's Director General Regions and Bases indicated that the DSC was not resourced to allow it to meet the performance requirements set out in the proposed SLA.

5.43 Subsequently, DFR Branch agreed to fund an increase in the number of customer service officers at the DSC and for these staff to be dedicated to the support of DFR services. A new SLA was signed on 29 May 2009. In February 2010, Defence informed the ANAO that at that time 17 additional customer service officers had been recruited (funded by DFR) and that the increased staffing had resulted in DSC meeting the SLA's requirements. Defence advised that the funding of these additional positions will be reviewed in 2010 to assess the requirement for continued supplementation.

5.44 In addition, during 2009 Defence provided CMG with additional funding of \$0.544 million to employ additional staff for the Candidate Relationship Management Centre (CRMC). This funding was provided to allow CMG to provide additional resources to the CRMC function in the early months of it taking over full operation and to cope with the increased number of potential recruits then in the recruiting pipeline. CMG subsequently agreed to contribute \$0.020 million per month to increase the staffing for the months of October, November and December 2009 (as set out in the Termination Deed).

5.45 Defence informed the ANAO that, during mid-2009, it had also put 15 ADF personnel into the DFRCs at locations throughout the country for periods of about three months to help manage the numbers of recruits in the pipeline. These ADF personnel directed their efforts to cleansing the data in the DFR information management system so that the efforts of the recruiting process more generally would be directed at those candidates who would be most likely to enlist.

Additional costs met by Defence during the New DFR Contract

5.46 In addition to the amounts paid for additional CRMC staff, and the use of ADF staff to assist in the recruitment process, Defence met the costs associated with the Local Area Marketing (LAM) arrangement during the contract with CMG.²¹⁰ Defence intended under the Statement of Work for the New DFR Contract that CMG provide this function. Defence has informed the ANAO that during transition in it became apparent that CMG was not in a position to assume the LAM responsibilities. In its 'without prejudice' submission, CMG claimed that the tender documentation for the New DFR Contract did not properly identify all items of DFR intended to be outsourced to the successful tenderer, including a third party supplier arrangement for LAM services. In respect of the period 1 February 2009 to 31 December 2009, over and above the payments made to CMG under the New DFR Contract, Defence paid \$1.724 million to the contractor providing LAM services, for a function Defence had intended would be provided by its recruitment services prime contractor.

5.47 Once the parties agreed to negotiate a termination of the DFR, Defence began the process of taking over a number of leases that CMG was responsible for under the New DFR Contract, which had expired, and were therefore operating on a month to month basis. CMG was not prepared to enter into new leases on six properties that were used for DFR purposes in view of the prospective termination of the contract. The total annual rent in relation to these six locations is \$1.065 million per annum. Defence continued to manage this process as the New DFR Contract was terminated, although CMG was to meet the costs of the leases until 31 January 2010.

5.48 From the above discussion it is clear that Defence, to ensure that DFR operations continued smoothly, has made payments for services that it had not anticipated when the New DFR Contract was signed. Defence has met costs that CMG was unwilling to meet. As at February 2010, it would appear that Defence had provided additional resources to CMG, directly and indirectly, of approximately \$2.3 million in value to assist DFR performance in the period February to December 2009. In addition, consistent with the collaborative nature of the DFR contracting arrangements, additional resources were

²¹⁰ LAM referred to an existing range of promotional activities for Army Reserve units and DFRCs that were delivered via a separate agreement (valued at approximately \$4.6 million per annum).

deployed in the DSC on DFR work and additional ADF personnel were provided to assist with the recruitment process.

Termination arrangements

Decision to mutually terminate the New DFR Contract

5.49 In its letter of 1 May 2009 responding to CMG's 'without prejudice' submission (referred to as 'the commercial plea' by Defence), Defence indicated, as part of its response, that:

... a deed of variation will be produced by [Defence] which ... releases the Commonwealth from all issues or claims that have been or could have been raised by CMG in connection with any matter arising prior to the date of the Contract variation.²¹¹

5.50 Following this letter, in mid-May 2009 there was an exchange of correspondence between the legal advisors of CMG and Defence. CMG's legal advisors claimed that it has become apparent that the Commonwealth had:

- engaged in misleading and deceptive conduct in relation to the Defence Department's DFR process and its capacity to ensure that CMG will be in a position to provide 10 500 enlisted recruits each year;
- breached its implied duty to cooperate with Chandler Macleod ...²¹²

5.51 CMG's legal advisors claimed that the New DFR model made it impossible for CMG to achieve the 10 500 per annum target because of serious flaws in the New DFR model. For example, CMG did not control the recruitment process where the Defence Service Centre was involved, and the New DFR system was not capable of handling the number of inquiries being received. In response to the proposed audit report, Defence informed the ANAO that these issues had not previously been raised in CMG's January 2009 commercial plea.

5.52 Following a number of exchanges between the parties, in a letter of 15 May 2009, Defence's legal advisors replied as follows:

It is clear that the parties hold different views with respect to both the facts, and the law applicable to those facts, in this matter. We note on behalf of

²¹¹ Letter from the Deputy Secretary, People Strategies and Policy, Department of Defence to the Managing Director of the Prime Contractor, 1 May 2009.

²¹² Letter from the Prime Contractor's legal advisors to Defence's legal advisors, 12 May 2009.

Defence that it does not accept your allegation that it has acted in a misleading or deceptive manner towards CMG at any time, nor does it accept that it has breached any duty to cooperate with CMG.

You have stated that CMG can and will perform its obligations under the Contract, and that is Defence's requirement for moving forward in this matter. In terms of that performance, CMG will be aware that the operational performance of the Defence Force Recruiting function and the achievement of outcomes is of paramount importance to Defence's interests.

If CMG believes that it has a legitimate entitlement based on the allegations made in your correspondence, and wishes to pursue this matter, then it should submit an appropriately specific claim, indicating the cause of action, the basis of any liability and the nature of the damage suffered. Any such claim will be treated in accordance with the *Legal Services Directions* under the *Judiciary Act 1903*, which preclude settlement unless a meaningful prospect of liability is established. We note that the defence of any such claim might be conducted by Comcover, the Commonwealth's insurer...

As we have responded to all of CMG's issues, and in the light of the above, Defence sees no value in meeting with CMG, unless, of course, CMG wishes to discuss with Defence an early exit from the agreement. On behalf of Defence, please advise CMG that all future communications between the parties in relation to this matter should be conducted through the parties' respective legal advisors.²¹³

5.53 Following receipt of this letter, CMG entered into discussions with Defence and its legal advisors regarding mutual termination of the New DFR Contract. In February 2010, CMG informed the ANAO that, from that point onwards, its key objectives were to maintain its reputation and minimise its costs associated with terminating the New DFR.

5.54 In a trading update to the Australian Stock Exchange of 19 May 2009, CMG stated:

The financial outcome of the contract with the Department of Defence was not in line with our original expectations. A significant impact on the ability to reach the original contract objectives has been the changes in the labour market arising from the serious economic downturn. The volume of recruits processed in the first half was lower than originally anticipated resulting in a shortfall in projected revenue. In addition there have been a number of unanticipated costs which contributed to a projected pre-tax loss on the

²¹³ Letter from Defence's legal advisors to the Prime Contractor's legal advisors, 15 May 2009.

Defence contract for the year to 30 June, 2009. We are currently assessing the mechanisms which could deliver an improved financial outcome for this half and better delivery of recruitment targets.²¹⁴

5.55 In this update CMG referred to a projected shortfall in revenue due to a lower level of recruits²¹⁵ and a number of unanticipated costs contributing to a projected loss on the New DFR Contract for the year ended 30 June 2009. In early 2010, in explaining how this situation had developed, CMG informed the ANAO that it had not fully comprehended the risks it was assuming in signing the contract.

Negotiation of the Termination Deed

5.56 A preparatory meeting of the respective legal teams occurred in late May, and an initial meeting involving Defence and CMG was held on 5 June 2009. The Deputy Secretary People Strategies and Policies issued a contract negotiation directive on 5 June 2009 to provide a framework for negotiations that was consistent with Defence's policy and legislative responsibilities. Key areas that Defence sought agreement on as part of any termination were:

- that CMG continue to perform the contract until termination arrangements occurred;
- that CMG agreed to remedy a number of areas of existing non-performance of the contract;
- contract payments would continue according to the contract, and Defence would provide additional payments or assistance as proposed in its letter of 1 May 2009;
- appropriate arrangements dealing with future claims and losses; and
- appropriate arrangements to protect the reputational interests of both parties.

²¹⁴ Chandler Macleod Group Limited, ASX Announcement *Trading Update – Core Business Performing Well in Tough Environment*, available from <<http://www.asx.com.au/asxpdf/20090520/pdf/31hp5h3ld6mk3z.pdf>> [accessed 21 October 2009].

²¹⁵ Defence advice to the ANAO, dated 31 May 2010, noted that the lower level of recruits was: 'as a result (at the time) of reduced recruiting achievement, rather than a reduction in recruiting targets set by Defence'.

5.57 In light of the discussions between the parties regarding mutual termination of the New DFR Contract, Defence requested advice from AGS on the probity of it proceeding with an interim recruitment services contract with the second placed tenderer in the New DFR Contract tender process—Manpower. On 18 June 2009, AGS provided the following advice:

In our view, and based on information provided by Defence, subject to Defence being able to form the view that it is achieving a value for money outcome consistent with the requirements of the *Commonwealth Procurement Guidelines* and Defence Procurement Policy Manual, we are of the view that it would be defensible from a probity perspective for Defence to formally approach Manpower with a view to putting in place an interim recruitment services contract with Manpower to cover the next two year period.²¹⁶

5.58 In a briefing of 29 June 2009 to the then Minister for Defence Personnel, Materiel and Science, Defence summarised its views on the best way forward, stating:

In summary, Defence favours transition to an interim solution while it re-examines the efficacy of the current outsourced recruiting model. Following consideration of legal advice, the most viable interim solution is a sole source procurement process with the previous contractor based on the overriding requirement to maintain effective recruiting operations ... the [proposed Termination] Deed includes a 'Condition Precedent' to ensure that termination is conditional upon Defence having a suitable interim solution in place.²¹⁷

5.59 The above comments indicate Defence's priority was to maintain DFR services on an ongoing and uninterrupted basis notwithstanding the prospective termination of the contractual arrangements with CMG.

5.60 The process of negotiating termination arrangements commenced in June 2009, although it was not until 2 October 2009 that both CMG and Defence had signed the Termination Deed. In a briefing to the Minister for Defence of 24 July 2009, Defence indicated:

CMG has demonstrated systemic and repeated failure to perform against the contract and it is considered more financially prudent to pursue termination

²¹⁶ Letter of 18 June 2009 from the Chief Counsel Commercial, AGS, to Defence, p. 1.

²¹⁷ Ministerial Submission of 29 June 2009 from the Deputy Secretary People Strategies and Policy to the Minister for Defence Personnel, Materiel and Science, p. 1.

by agreement than engage in a potentially heavily fought dispute with an organisation in financial stress.²¹⁸

Alternative to termination

5.61 An alternative available to Defence in the circumstances it found itself in relation to the operation of the New DFR Contract was to explore options with CMG to provide a short term operating solution while longer term arrangements (possibly involving a full re-tender) were determined.²¹⁹ In terminating the New DFR Contract, Defence was faced with the costs associated with termination and with transitioning in a replacement contractor. However, Defence noted that CMG had made a very broad claim for additional revenue as part of its 'without prejudice' submission which was rejected by Defence. In addition, Defence indicated that it considered there was a real prospect that if CMG was to continue as DFR provider for the remainder of the New DFR Contract, even under amended terms, that further performance issues and claims would arise, and there was a significant risk of the ultimate failure of the whole contract.²²⁰

5.62 In its dealings with CMG, Defence and its legal advisors placed heavy reliance on the provisions of clause 31 of the New DFR Contract (see discussion of risk at paragraphs 3.81 and 3.85). Clause 31 refers to the retained functions of Defence and any fluctuation in volumes arising from Defence exercising its retained functions. In addition, under clause 31, the prime contractor acknowledges that it will bear the risk of all fluctuations in volumes (regardless of how they arise) and that it has included appropriate costs in preparing its tender. Based on clause 31, Defence argues that CMG had accepted that the risk associated with any variation to recruitment targets was the responsibility of CMG. In response to the proposed audit report, Defence further informed the ANAO that:

in any case, variation in recruitment targets, to any detriment of the contractor, did not eventuate prior to CMG seeking termination of the contract. Annual

²¹⁸ Ministerial Submission of 24 July 2009 of the Deputy Secretary People Strategies and Policy to the Minister for Defence, p. 3.

²¹⁹ In response to the proposed audit report, Defence informed the ANAO that it did not consider this option was open to it for a range of reasons, including probity concerns that a contract variation of this nature would change the basis of the original value for money assessment made during a competitive tender process. Defence further stated that this view is consistent with the advice Defence received from its legal advisers.

²²⁰ Letter of 11 February 2010 from Clayton Utz to DGDFR, p. 11.

recruitment target levels did not fall below 11 000 in this period, 4.8 per cent more than the standard RFT scenario, and the forecast annual recruitment levels for the following year (2009–10) were also greater than the standard RFT scenario.²²¹

5.63 This same provision (clause 31, related to retained functions) is present in the Interim Contract for DFR services which Defence signed on 14 December 2009 with Manpower for the provision of DFR services from 1 February 2010. However, the impact is mitigated to some extent by the inclusion in that contract of two pricing bands for the purposes of determining the fixed fee and per head recruitment fee. Under the Interim DFR Contract, one pricing band applies if annual recruitment vacancies are at or below 9500, and another band applies if annual recruitment vacancies are above 9500. This contrasts with the 10 500 annual vacancies discussed within the context of the original tender for the New DFR Contract. However, under the Interim Contract the design of the New DFR model remains the same, with the prime contractor and Defence contributing jointly to successful enlistment outcomes and therefore the prime contractor continues to retain certain risks related to Defence's retained functions.

Key provisions of the Termination Deed

5.64 In developing the Termination Deed, Defence received advice from both its legal advisers (Clayton Utz and the Australian Government Solicitor). During the negotiation process, CMG made a number of claims to obtain additional concessions from Defence as part of the transition out arrangements. A key claim by CMG was to continue to receive its fixed and per head recruitment fee during what is termed in the New DFR Contract and the Termination Deed as 'the liability period'.²²² Defence rejected that claim and also rejected any liability relating to commercial disputes between CMG and any of its sub-contractors arising from the termination of the New DFR Contract, which was another area in respect of which CMG had made a claim.

²²¹ However, CMG was experiencing revenue shortfalls at this time because of a drop in early 2009 in terms of recruitment achievement.

²²² This is a period of three months occurring after the conclusion of the Prime Contractor (CMG) providing DFR services but during which the Contract Administrator may require the Prime Contractor to perform, or re-perform, relevant services and take all steps reasonably necessary to mitigate the effect on Defence of any failure to perform contracted services.

5.65 The following are key matters that were included in the Termination Deed of 2 October 2009:

- transition out by CMG was to be completed by 1 February 2010 (clause 4.2):
 - by then CMG would have completed one year of the initial five year term of the New DFR Contract;
- Defence attempted to exert more control and direction over the transition out arrangements (clause 4.2) than was present under the original New DFR Contract;
- Defence agreed that it could direct CMG to perform or re-perform services under the contract provided that such direction is for action by CMG to be completed by 1 March 2010 (one month after the completion of the transition out period) (clause 4.2):
 - this contrasts with the provision in the New DFR Contract (clause 26.2) that CMG could be requested to perform or re-perform services up to the end of the liability period (three months after the completion of the transition out period);
- Defence agreed to a reduction in the scope of services to be provided by CMG compared with the New DFR Contract, while CMG would continue to have responsibility for the delivery of the core recruitment services until 1 February 2010 (clause 4.3);
- Defence agreed to amend the KPI on recruitment achievement from '100 per cent against vacancies' to '85 per cent against vacancies' (clause 4.5):
 - this represented a significant reduction in the performance target that had applied since the contract was signed in July 2008;
- Defence agreed to pay for a number of matters (such as the lease costs on Brisbane and Maroochydore DFRC property leases and fit-out costs for the DFRC ACT premises) that were, in part, the subject of CMG's 'without prejudice' submission—commercial plea—of 30 January 2009 (clause 5.2):
 - Defence informed the ANAO that the total costs associated with meeting these commitments was \$1.6 million (excluding GST);

- CMG agreed to pay Defence \$2 million in compensation for the costs or expenses which Defence had incurred or will incur directly or indirectly as a result of the early termination of the contract (clause 14.1):
 - in August 2009 Defence informed the ANAO that it estimated the direct costs resulting from the early termination of the New DFR Contract would be \$2.9 million;
 - this estimate included certain costs associated with terminating the contract and establishing a new interim contract with another provider. The estimate included no provision related to any premium that Defence is likely to pay for DFR services for the next four years;
 - in April 2010 Defence informed the ANAO that its actual direct expenditure related to termination matters was \$2.5 million based on the best information available at that time, which is less than the \$2.9 million estimate made in August 2009;
- Defence agreed to pay \$2 million to CMG, subject to Defence being satisfied that CMG met the requirements of the transition plan, complied with the Termination Deed and the New DFR Contract, and met or exceeded the transition KPIs during the transition out period (clause 11):
 - while the costing of the original tender from CMG included approximately \$2.7 million as transition out costs, it is not clear whether Defence was under any obligation to assist CMG by paying a pro-rata amount of CMG's transition out costs. The payment of the \$2 million could therefore be seen as a payment that helps facilitate the conclusion of the contract. The ANAO notes that it is equal to the amount of Defence costs that CMG has agreed to pay Defence;
- both Defence and CMG released each other from any claims that either of them may have against the other related to the contract and its termination (clause 15); and
- apart from CMG's legal or regulatory disclosure requirements, CMG undertook not to disclose information that the Commonwealth

designates is confidential or which ought to be inferred from the circumstances as confidential (clause 16.13).²²³

5.66 On 11 December 2009, Defence signed an Amending Deed with CMG. The key provision in the Amending Deed was that a number of sub contracts, or their equivalent functions, became the responsibility of Defence's alternative provider (Manpower) from 21 December 2009, rather than 31 January 2010 (clause 7). The Amending Deed made no adjustment to the payments to CMG in relation to this reduction in services.

Consideration of matters concerning the Termination Deed

5.67 Defence has taken advice from its legal advisers throughout this process and, based on the available evidence, has followed that advice. AGS advised in a letter of 15 October 2009 that:

in relation to the Termination Deed, in our view, based on the information provided to us by Defence concerning the critical need to maintain DFR services on an ongoing and uninterrupted basis, our direct involvement in negotiations between Defence and CMG on the proposed Deed of Termination, and our review of the Deed as now finally negotiated with CMG, it would be defensible from a legal process, and Commonwealth contracting and financial management policy perspective, for Defence to enter into this Deed with CMG.

It is important to note, however, that in providing this advice, AGS relied on the accuracy and completeness of the information provided to us by Defence, and in particular, the estimates provided to us by Defence of the costs it has or will incur as a result of the early termination of the CMG contract.²²⁴

5.68 The 15 October letter from AGS provides some further insight into the thinking involved in regards to the termination and Defence's approach to it:

In our view, the continuation of the (then) existing Contract with CMG carried with it, on the information available to us, a number of significant risks, such as:

²²³ In an Investor Presentation published on the ASX web site on 24 September 2009, the Prime Contractor indicated: 'The contract was not viable. The problem was the contract.' On 8 October 2009 Defence's legal advisors wrote to the Prime Contractor's legal advisors expressing disappointment with 'The problem was the contract' comment and similar comments in the Prime Contractor's Annual Report.

²²⁴ Letter of 15 October 2009 from the Chief Counsel Commercial and Senior Executive Lawyer, AGS, to Defence, p. 3.

- a. that CMG would continue to seek compensation from Defence on the basis of its previously submitted commercial plea and argue for significant variations to its Contract with Defence;
- b. that CMG's delivery of recruitment services would be adversely affected by its ongoing difficult and challenging financial situation;
- c. that CMG may default under its contract with Defence; and
- d. that as a result, there would be a real risk to the ongoing and uninterrupted delivery of Defence Force recruiting services.²²⁵

5.69 The matters outlined in the letter from AGS do not include some other relevant issues, including that: the design of the contracting model included features through which Defence's actions within the recruitment process and policy on recruitment targets can affect contractor revenue, regardless of the contractor's performance; and weaknesses existed in the material supplied by Defence in the Statement of Work provided to tenderers. These issues have affected the circumstances that led to the parties agreeing the termination of the New DFR Contract in October 2009 (subject to the satisfaction of a condition precedent see paragraph 5.58), with effect from 1 February 2010.

5.70 Defence's financial advisors, in a paper provided to Defence in mid-2009, commented:

By necessity, increasing the proportion of revenue at risk reduced the level of fixed remuneration available for the successful tenderer. The new scheme was not designed to ensure all fixed costs associated with the contract were covered by revenues from Defence, hence from the service providers point of view there was a clear risk of losing money on the engagement should they fail to achieve their intended recruitment levels.²²⁶

5.71 From its analysis of available information the ANAO considers that with the New DFR contract as signed, the weaknesses in the data on which the contract was based (see paragraphs 3.21 to 3.33) and the difficulties encountered during the introduction of the New DFR (see paragraphs 4.22 to 4.45), there existed a number of factors which contributed to the lack of profitability of the New DFR Contract. In addition to these matters which were apparent to both parties in the first half of 2009, reductions in Defence's

²²⁵ Letter of 15 October 2009 from the Chief Counsel Commercial and Senior Executive Lawyer, AGS, to Defence, p. 4.

²²⁶ KPMG, paper headed 'Part 1: Pricing Model', p. 2.

recruitment target which occurred later in 2009 would have reduced CMG's potential profitability in 2009–10 had the New DFR Contract continued to operate.

5.72 The ANAO considers that both CMG and Defence have had in their control factors which contributed to the New DFR Contract ultimately being terminated. In early 2010, in explaining how the New DFR had affected its operations, CMG informed the ANAO that it had not fully comprehended the risks it was assuming in signing the contract. Weaknesses in the material Defence made available to tenderers during the New DFR Contract process increased risks to tenderers, especially those other than the incumbent. Inefficiencies associated with the New DFR model would also have added to a contractor's difficulties.

5.73 In discussions with the ANAO, Defence has indicated that it was concerned that, if it pressed CMG too strongly, CMG's financial position may have been made more difficult which would have added to the risk of ensuring ongoing DFR services. Defence also did not, as an alternative to terminating the New DFR Contract and sole sourcing the previous prime contractor as an interim provider, approach CMG to explore the option of negotiating some short term relief for the company ahead of once again approaching the market with a new tender. If a viable option had been able to be negotiated with CMG, Defence would have avoided the cost of changing providers twice in a relatively short period (less than 18 months). Defence informed the ANAO that, in all the circumstances, it did not seek to negotiate an interim arrangement with CMG while seeking a longer term solution and informed the ANAO that

a number of factors led to this decision, including that a contract variation of the magnitude sought by CMG would likely give rise to probity concerns, as the variation would change the basis for the original value for money assessment of a competitive tender. This view is consistent with the advice of Defence's legal advisers.²²⁷

Financial implications

5.74 Central to its approach to negotiating the Termination Deed was Defence's critical imperative for the recruitment process for the ADF to proceed unaffected by CMG ceasing its involvement and to achieve a smooth

²²⁷ Defence advice to the ANAO dated 31 May 2010.

transition to alternative recruitment service arrangements. Defence's actual direct costs of termination (\$2.5 million) included no provision for the higher cost of DFR services that Defence is having to pay following the termination of the contract with CMG. Under the Termination Deed Defence is likely to recoup \$2 million, less than its direct costs of termination. In respect of the security provided by CMG under the New DFR Contract, Defence has informed the ANAO that it has no specific intention to access the security under the New DFR Contract to meet additional costs it will have to meet flowing from the termination of the contract.

5.75 In April 2010 Defence informed the ANAO that it made payments associated with the termination of the contract of \$3.9 million (excluding GST) (\$1.6 million for various lease and fit-out costs and \$1.8 million as a transition out incentive, as well as \$0.5 million in direct costs not being recovered). In addition, Defence is limiting the liability of CMG and receiving no compensation for any higher fees that it may have to pay for recruitment services during the next four years.

5.76 In addition, in relation to the replacement contract that Defence has put in place, the department is paying \$8.2 million (excluding GST) in transitional milestone payments to an alternative provider, Manpower, which included some payments related to the work of sub-contractors (that were already covered in Defence's contract with CMG). Accordingly, the total amount that Defence is meeting to change providers is \$12.1 million (excluding GST). The payments made to Manpower in transition to the Interim Contract (under which it provides full DFR recruiting services from 1 February 2010) included \$3.1 million related to the work of sub-contractors for functions (covering the period 21 December 2009 to 31 January 2010) that were already covered in the contract with CMG (under which CMG was paid to deliver DFR services until 31 January 2010). To facilitate the termination and transition, Defence has effectively paid twice for certain services between 21 December 2009 and 31 January 2010.

5.77 Over and above the cost associated with changing providers, Defence estimates that it is paying a premium of 15 per cent (over the prices tendered by Manpower in 2008) in the Interim Contract for DFR services from 1 February 2010.²²⁸ The ANAO observes that the original Manpower bid was

²²⁸ Minute of 14 December 2009 from DGDFR to Deputy Secretary People Strategies and Policy, p. 4.

4.7 per cent in excess of CMG's bid, bringing the premium over the previous successful tenderer to approximately 20 per cent for the two year period of the interim contract. Given the weaknesses in the data supporting the original RFT, the shorter contract period involved and the reduction in Defence's recruitment targets, there is some justification for an increase in the price to be paid by Defence for DFR services under the Interim Contract. This audit did not examine whether the quantum of the premium was appropriate.

5.78 Given its imperative of maintaining uninterrupted recruitment services, Defence has not been in a strong negotiating position with CMG in regards to recouping its costs associated with the termination of the New DFR Contract. Defence has had to assume a number of responsibilities to keep the recruitment process operating, as well as the associated costs, and undertake yet another tender process for which it anticipates recouping a portion of its costs.

5.79 CMG signed the New DFR Contract on 2 July 2008 and signed a Termination Deed on 2 October 2009 (and a subsequent Amending Deed on 11 December 2009). In an Australian Stock Exchange Announcement of 16 September 2009, CMG stated: 'the effect of the contract to manage Defence Force Recruiting ("DFR") process for the year ended 30 June 2009 was an operating loss after tax of \$3.8 million.'²²⁹ In CMG's Annual Report to shareholders of 16 September 2009, the company referred to a provision for New DFR Contract losses for the period 1 July 2009 to 1 February 2010 of \$5.9 million (after tax), bringing its total estimated loss on the New DFR Contract to \$9.7 million (after tax) at that time.²³⁰

5.80 In a further statement on 10 February 2010, CMG announced that it will be necessary to write back between \$6.0 million and \$8.0 million (before tax) of the prior period provision \$8.4 million (before tax) made in respect of the period 1 July 2009 to 31 January 2010.²³¹ Accordingly, CMG's loss under the

²²⁹ Chandler Macleod Group Limited, ASX Announcement *Chandler Macleod announces early exit from Defence Force Recruiting contract and revised result for year ended 30 June 2009*, available from <<http://www.asx.com.au/asxpdf/20090916/pdf/31krc332bfv24c.pdf>>. CMG informed the ANAO that the loss reported was \$5.3 million (before tax) to 30 June 2009.

²³⁰ Chandler Macleod Group Limited, ASX Announcement *Annual Report to Shareholders*, available from <<http://www.asx.com.au/asxpdf/20090916/pdf/31krjbyw8kh7fy.pdf>>.

²³¹ Chandler Macleod Group Limited, ASX Announcement *Chandler Macleod announces successful transition out of Defence Force Recruiting (DFR) Contract – write back of previous provision required*, available from <<http://www.asx.com.au/asxpdf/20100210/pdf/31nmbmcl0ydmq8.pdf>>.

contract in the seven months to 31 December 2010 was not as great as originally expected. It should be noted that even though CMG ceased being responsible for DFR operations related to the New DFR Contract on 31 January 2010, the liability period does not cease for a further three months.



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17 June 2010

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