

Department of Defence's Procurement of Six Evolved Cape Class Patrol Boats

Department of Defence

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Canberra ACT
16 December 2021

Dear Mr President
Dear Mr Speaker

In accordance with the authority contained in the *Auditor-General Act 1997*, I have undertaken an independent performance audit in the Department of Defence. The report is titled *Department of Defence's Procurement of Six Evolved Cape Class Patrol Boats*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit to the Parliament.

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

Yours sincerely



Grant Hehir
Auditor-General

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

AUDITING FOR AUSTRALIA

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Audit snapshot

Auditor-General Report No.15 2021–22

Department of Defence's Procurement of Six Evolved Cape Class Patrol Boats



Why did we do this audit?

- ▶ On 30 April 2020, the Department of Defence (Defence) contracted Australian shipbuilder Austal Ships Pty Ltd (Austal Limited) to deliver six new evolved Cape class patrol boats.
- ▶ The audit will provide independent assurance to the Parliament on the effectiveness of the procurement, including Defence's assessment of value for money in the context of a sole source acquisition.



What did we find?

- ▶ Defence's procurement to date of six evolved Cape class patrol boats has been largely effective.
- ▶ Defence's decision-making and procurement activities were largely effective.
- ▶ Defence has implemented largely appropriate contracting, governance and reporting arrangements to support the acquisition.



What did we recommend?

- ▶ One recommendation was made to Defence to develop and implement specific requirements for the management of probity when engaging with industry on unsolicited proposals.
- ▶ Defence agreed to the recommendation.



Key facts

- ▶ The decision to acquire six new evolved Cape class patrol boats rather than undertake the life-of-type extension of Navy's existing Armidale class patrol boats as planned, was made following receipt of an unsolicited proposal from Austal in September 2019.

\$356.8m

(GST inclusive) acquisition contract value at contract signature (April 2020).

5–9 months

delay to introduction into service of evolved Cape class patrol boats as of July 2021.

2–21 months

extended planned withdrawal dates for seven Armidale class patrol boats as of July 2021.

Summary and recommendations

Background

1. On 30 April 2020, the Department of Defence (Defence) contracted Australian shipbuilder Austal Ships Pty Ltd (Austal or Austal Limited)¹ to deliver six new Evolved Cape Class Patrol Boats (ECCPBs or evolved Cape class), valued at \$356,795,568 (GST inclusive). This procurement was not outlined as an area of Defence investment in the 2016 Defence publication, *Integrated Investment Program*.² To acquire the six new ECCPBs, Defence undertook a limited (sole source) procurement, following receipt of an unsolicited proposal from Austal on 5 September 2019.
2. Prior to receiving this proposal, Defence had been developing a life-of-type extension (LOTE)³ plan which included a full LOTE for six of the Australian Defence Force's (ADF) current fleet of 12 Armidale Class Patrol Boats (Armidale class) and a partial LOTE for three vessels. This approach was in line with the November 2017 approval by the Australian Government of an indicative capability transition plan to transition from the Armidale class to a new fleet of 12 Arafura Class Offshore Patrol Vessels (Arafura class or OPVs).
3. In addition to the Armidale class LOTE, the government's approved indicative plan (costed at \$103.7 million) involved an extension of Defence's existing lease of two Cape class Patrol Boats (Cape class). In April 2020, Defence sought government approval to amend the transition plan by acquiring the six ECCPBs and discontinuing the Armidale class LOTE.

Rationale for undertaking the audit

4. The decision to acquire six new evolved Cape class patrol boats rather than undertake the life-of-type extension of Navy's existing Armidale class patrol boats as planned, was made following receipt of an unsolicited proposal from Austal Limited to Defence in September 2019 outlining a leasing arrangement. At the time of receipt, Defence had not planned for or approached the market for this specific capability. The audit will provide independent assurance to the Parliament of the effectiveness to date of the procurement, including Defence's assessment of value for money in the context of a sole source acquisition process.

Audit objective and criteria

5. The objective of the audit was to assess the effectiveness to date of the Department of Defence's procurement of six evolved Cape class patrol boats.

1 The new registered business name for Austal Ships Pty Ltd is Austal Limited.

2 Department of Defence, *Integrated Investment Program*, 2016, available from <https://www1.defence.gov.au/about/publications/2016-defence-white-paper> [accessed 4 November 2021]. Paragraphs 4.4 and 4.34 indicated that new investments to build the capability and capacity of Australia's maritime force included 12 patrol vessels capable of more extended operations than the existing Armidale class patrol boats. Paragraph 4.35 stated that 12 offshore patrol vessels would replace the 13 existing Armidale Class patrol boats.

3 LOTE refers to the work to be undertaken to extend the effective service life of the vessel beyond its original service life. [Armidale Class Patrol Boat Life-of-Type Extension Project Execution Strategy, Department of Defence, p. 5].

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

- Did the Department of Defence (Defence) effectively assess its capability requirements and options?
- Did Defence conduct an effective procurement process that supported the achievement of its capability requirements and value for money?
- Did Defence effectively advise government?
- Has Defence established fit-for-purpose contracting arrangements for the acquisition?
- Has Defence established fit-for-purpose governance arrangements for the acquisition?
- Is Defence meeting program milestones and supporting the delivery of capability requirements?

Conclusion

7. Defence's procurement to date of six evolved Cape class patrol boats has been largely effective.

8. Defence's decision-making and procurement activities were largely effective. Following receipt of an unsolicited proposal from Austal for the lease of six new Cape class patrol boats in September 2019, Defence effectively assessed its capability requirements and options. Defence's subsequent sole source tender was largely effective and supported the achievement of value for money and Defence's capability requirements. Defence did not assess potential probity risks on receipt of the unsolicited proposal or introduce additional arrangements to manage probity risk until exclusive negotiations commenced in February 2020. Defence's advice to government was largely effective, although it could have been more clearly presented.

9. Defence has implemented largely appropriate contracting, governance and reporting arrangements to support the acquisition. Two mandated governance documents had not been approved as at 1 December 2021, and no independent assurance reviews have been conducted to date. Therefore, Defence and its senior leaders have not had the benefit of the full suite of inputs which help provide assurance that capability requirements are being successfully delivered. Defence has undertaken an appropriate range of activities to date to manage project milestones. However, anticipated delivery delays of 26 to 35 weeks, resulting from the contractor's need to undertake rectification work following the use of defective aluminium, and the production workforce inefficiencies it has reported, have required Defence to plan for the extension of service of Armidale class patrol boats and a reduced in-service period for the evolved Cape class. As of July 2021 net additional costs arising from projected delays for the delivery of the evolved Cape class and the Offshore Patrol Vessels are estimated by Defence at \$43.9 million.

Supporting findings

Assessment of the proposal

10. Defence assessed the unsolicited proposal received from Austal largely in accordance with the Defence Procurement Policy Manual (DPPM) requirements, which incorporate the Commonwealth Procurement Rules (CPRs). To improve clarity and transparency regarding the

handling of unsolicited proposals received by Defence, there would be merit in Defence clarifying the procedures to be applied by officials handling unsolicited proposals. Defence applied a series of processes to assess and develop the proposal, including a Risk Reduction Design Study. A limited tender (sole source) Request for Tender process was conducted based on the exemption under paragraph 2.6 of the CPRs, and the basis for exemption from the competition requirements of the CPRs was documented. Defence did not prepare a written procurement plan as required under the DPPM for procurements valued at or above \$200,000. (See paragraphs 2.6 to 2.53)

Assessment of value for money

11. Defence's assessment of value for money of Austal's sole source tender was largely appropriate. In the absence of market testing, Defence relied on its benchmarking of Austal's costs with internally held information on Cape class costs acquired by Defence as part of the leasing arrangements for two Cape class patrol boats in Navy service, and information gathered in the context of planning the Armidale class life of type extension. Key decision documents did not include a cost comparison or document consideration of the Australian Customs and Border Protection Service's earlier acquisition of eight Cape class patrol boats for the Commonwealth. (See paragraphs 2.54 to 2.74)

Management of probity

12. Defence did not assess potential probity risks on receipt of the unsolicited proposal from Austal in September 2019 or introduce additional arrangements to manage procurement probity risk until it commenced exclusive negotiations with Austal in February 2020. This was five months after receipt of the proposal.

13. It would have been prudent for Defence to consider its probity arrangements for its personnel earlier than it did. Defence records indicate that prior to receipt of the unsolicited proposal, Austal personnel provided Defence personnel with information and modelling relating to the idea of acquiring additional Cape class boats as an alternative to the Armidale class LOTE, to support Navy's transition to the Arafura class offshore patrol vessels (OPVs). While the ANAO did not identify direct evidence of joint development of the unsolicited proposal before it was formally received, and Defence advised that joint development did not occur, in such circumstances care needs to be taken to avoid the perception of joint development of a proposal which may result in procurement action, so as to avoid any perception that potential suppliers enjoy an unfair advantage. Non-discrimination is a key principle of the CPRs. (See paragraphs 2.75 to 2.93)

Advice to government

14. Defence's advice to government was largely effective. The advice was timely, but it did not always fully or clearly present the risks, costs and impacts associated with the transition plan for the Navy's patrol boat force, or the rationale supporting the evolved Cape class procurement. (See paragraphs 2.94 to 2.102)

Contracting arrangements

15. Defence has established fit-for-purpose contracting arrangements for the acquisition. Defence's contract with Austal includes 20 milestones, with clear entry and exit criteria and due

dates. Contract payments are tied to the achievement of milestones. Payment amounts are appropriately distributed to incentivise satisfactory contractor performance, with amounts held over until achievement of acceptance milestones. Performance expectations are clearly set out in the contracted statement of work, with additional detail about consequences for poor performance included in the conditions of contract. Provisions for corrective action are included in the contract, as are provisions for the payment of liquidated damages. (See paragraphs 3.3 to 3.20)

Governance arrangements

16. Defence has established largely fit-for-purpose governance arrangements for its acquisition of six evolved Cape class patrol boats. The governance, oversight and coordination arrangements for the project include a combination of project-specific governance and oversight groups, as well as higher-level oversight and coordination arrangements for Defence's naval shipbuilding activity as a whole. The management of this acquisition is through CASG's sustainment arm. Defence has recognised the risk and complexity of these non-standard administrative arrangements, with the anticipated benefits expected to outweigh the risk.

17. Two mandated governance documents — the Product Delivery Agreement (Materiel Acquisition Agreement) and Integrated Project Management Plan — had not been approved as at 1 December 2021, and no independent assurance reviews have been conducted to date. As a consequence, Defence and its senior leaders have not had the benefit of the full suite of inputs which contribute to providing assurance that capability requirements are being successfully delivered by an acquisition project. (See paragraphs 3.21 to 3.70)

Delivery of requirements

18. Defence has undertaken an appropriate range of activities to date to manage project milestones, with the intent of supporting the delivery of capability requirements. Defence records indicate that as of August 2021, delays of 26 to 35 weeks are projected for boat delivery compared to contracted milestones, due to the contractor's need to undertake rectification work following the use of defective aluminium and production workforce inefficiencies reported by the contractor. In July 2021 Defence estimated that net additional costs arising from projected delays, along with OPV delays, have contributed to an increase of \$43.9 million to OPV transition costs. This has resulted in the planned extension of service of the Armidale class and a reduced in-service period for the evolved Cape class, demonstrating the consequential effect of project schedule delays to ADF capability and the Australian Government's naval shipbuilding strategy. As noted above, Defence's acquisition contract for the six evolved Cape class patrol boats includes provisions for the payment of liquidated damages. (See paragraphs 3.71 to 3.105)

Recommendations

- Recommendation no. 1** The Department of Defence develop and implement specific requirements for the management of probity when engaging with industry on unsolicited proposals including by identifying, assessing and managing probity risk at an early stage, when considering and assessing the feasibility of unsolicited proposals.
- Paragraph 2.87**

Department of Defence response: *Agreed.*

Summary of Department of Defence's response

19. The Department of Defence's summary response is provided below and its full response (comprising two items of correspondence) is included at Appendix 1.

The Department of Defence acknowledges the findings contained in the audit report on Defence's Procurement of Six Evolved Cape Class Patrol Boats, which focused on assessing the effectiveness to date of the Department's procurement of six evolved Cape class patrol boats. Defence concurs with the findings that the procurement arrangements and decision making processes were largely effective.

The unsolicited proposal for six evolved Cape class patrol boats represented an opportunity for Defence to reduce the risk of the patrol force transition plan through negating the need for life of type extensions to some of Defence's existing Armidale class patrol boats.

Defence welcomes positive engagement with our industry partners where it delivers superior capability outcomes and value for money for the Australian Defence Force. Defence acknowledges and understands the need to ensure that such engagement is appropriately managed, as it has been in this case, and will strengthen the guidance in relation to identifying and managing probity risks early in the process when considering unsolicited proposals.

20. At Appendix 2, there is a summary of improvements that were observed by the ANAO during the course of the audit.

Key messages from this audit for all Australian Government entities

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

Procurement

- The effective and ethical conduct of procurement processes is supported by the early identification and management of probity risks, including in respect to any early engagement with potential tenderers.
- Non-discrimination in procurement is supported by documented processes for the handling of unsolicited proposals.
- Confidence in procurement outcomes is strengthened where staff directly involved in procurement make activity specific conflict of interest declarations in addition to any general declarations required as part of their employment.

- Confidence in procurement outcomes is further strengthened where an entity has documented how value for money will be demonstrated in the context of a sole source procurement, such as through benchmarking against a recent comparable procurement.
- The effective management of unsolicited proposals by government entities is supported by the Commonwealth Procurement Rules and entity guidelines which inform their handling and assessment, including probity considerations.

Policy/program implementation

- The timely development of key project management documentation is necessary for entities to monitor the progress of contract deliverables.

Audit findings

1. Background

Introduction

1.1 On 30 April 2020, the Department of Defence (Defence) entered into a contract for \$356,795,568 with Australian shipbuilder Austal Ships Pty Ltd (Austal or Austal Limited)⁴ to deliver six new Evolved Cape Class Patrol Boats (ECCPBs or evolved Cape class). This procurement was not outlined as an area of Defence investment in the 2016 Defence publication, *Integrated Investment Program*.⁵ To acquire the six new ECCPBs, Defence undertook a limited (sole source) procurement⁶, following receipt of an unsolicited proposal from Austal on 5 September 2019.

1.2 Prior to receiving this proposal, Defence had been developing a life-of-type extension (LOTE)⁷ plan which included a full LOTE for six of the Australian Defence Force's (ADF) current fleet of 12 Armidale Class Patrol Boats (Armidale class) and a partial LOTE for three vessels. This approach was in line with the November 2017 approval by the Australian Government of an indicative capability transition plan to transition from the Armidale class to a new fleet of 12 Arafura Class Offshore Patrol Vessels (Arafura class or OPV).⁸

4 The new registered business name for Austal Ships Pty Ltd is Austal Limited.

5 Department of Defence, *Integrated Investment Program*, 2016, available from <https://www1.defence.gov.au/about/publications/2016-defence-white-paper> [accessed 4 November 2021]. Paragraphs 4.4 and 34 indicated that new investments to build the capability and capacity of Australia's maritime force included 12 patrol vessels capable of more extended operations than the existing Armidale class patrol boats. Paragraph 4.35 stated that 12 offshore patrol vessels would replace the 13 existing Armidale Class patrol boats.

6 The applicable version of the Commonwealth Procurement Rules (CPRs) sets out that: 'Australian Government procurement is conducted by open tender or limited tender.' (Australian Government, Department of Finance, *Commonwealth Procurement Rules*, 20 April 2019, para. 9.1). In this case the limited tender was confined to a single tenderer. To do so, Defence relied on paragraph 2.6 of the CPRs, which states that 'These CPRs do not apply to the extent that an *official* applies measures determined by their *Accountable Authority* to be necessary for the maintenance or restoration of international peace and security, to protect human health, for the protection of essential security interests, or to protect national treasures of artistic, historic or archaeological value.' The Defence Procurement Policy Manual (DPPM) outlines that the Secretary of Defence has determined, for paragraph 2.6 of the CPRs, that the procurement of goods under Federal Supply Code 19 Ships, Small Craft, Pontoons and Floating Docks is exempt from the operation of Division 2 of the CPRs. (Department of Defence, *Defence Procurement Policy Manual*, 1 July 2019, pp. 32-34). Where it applies, Division 2 of the CPRs establishes conditions for limited tender (ie. defines the circumstances in which a limited tender over the procurement threshold may be undertaken). The DPPM also states that 'if a procurement is exempt from Division 2 of the CPRs, Defence *officials* are still required to undertake their procurement in accordance with Division 1 of the CPRs.' (DPPM, p. 34). Division 1 of the CPRs sets out the rules for all procurements, including the requirement that '*Officials* responsible for a *procurement* **must** be satisfied, after reasonable enquires, that the *procurement* achieves a value for money outcome' (CPRs, paragraph 4.4) [emphasis in original].

7 LOTE refers to the work to be undertaken to extend the effective service life of the vessel beyond its original service life (Armidale Class Patrol Boat Life-of-Type Extension Project Execution Strategy, Department of Defence, p. 5).

8 Defence's acquisition of the Arafura class was reviewed in Auditor-General Report No.12 2020–21 *Defence's Procurement of Offshore Patrol Vessels — SEA 1180 Phase 1*.

1.3 In addition to the Armidale class LOTE, the government approved indicative plan involved an extension of Defence's existing lease of two Cape Class Patrol Boats (Cape class) to support transition to the Offshore Patrol Vessel (OPV).⁹

1.4 In April 2020, Defence sought government approval to amend the transition plan by acquiring the six ECCPBs and discontinuing the Armidale class LOTE. The government approved the acquisition of six ECCPBs on 6 April 2020. The government also agreed that the Minister for Defence and Minister for Finance would determine the appropriate funding method — either to lease, purchase outright, or a combination of both by exchange of letters. The government approved an amount of \$1.126 billion for direct purchase or \$1.194 billion for lease, which included \$322.2 million (GST exclusive) for the price of the boats and \$7.8 million for capitalised interest if the boats were leased.

1.5 On 30 April 2020 the Minister for Finance wrote to the Minister for Defence agreeing to the purchase of six ECCPBs from Austal at a total cost of up to \$345.5 million. This amount was less than agreed by the government due to the decision to purchase outright, as the 6 April 2020 government approval included \$7.8 million in capitalised interest from leasing.

1.6 On 30 April 2020, Defence and Austal signed a contract for the acquisition and build of six ECCPBs. The contract value was \$356,795,568 (GST inclusive).

The Evolved Cape Class Patrol Boats: SEA 1445-1

1.7 The Deputy Secretary of Defence's Capability Acquisition and Sustainment Group (CASG) and the Chief of Navy received, on 5 and 6 September 2019 respectively, an unsolicited proposal from the Chief Executive Officer of Austal. The proposal stated that:

Austal has identified a potential cost saving and risk reduction initiative relating to the Commonwealth's patrol boat fleet that may interest both the Government and the Royal Australian Navy (RAN). This initiative would also support workforce continuity in Henderson [naval shipyard, Western Australia] as part of a broader requirement to ensure capability is retained for future Commonwealth naval sustainment and shipbuilding programs.

Specifically the initiative is that the RAN lease 6 new Cape Class vessels (CCPBs) in addition to the 2 CCPBs already in service and retire early the 13 Armidale Class Patrol Boats (ACPBs) rather than perform any life of type extension (LOTE) work. A fleet of 8 CCPBs is estimated to be sufficient to maintain patrol force availability above the target of 250 days / month through the transition period to the new OPVs.

... The total through life cost savings of this initiative for the RAN Patrol boat fleet is estimated at **100 – 150 M AUD over 8 years** [emphasis in original].¹⁰

9 The 2016 *Defence White Paper* noted the government's intention to acquire 12 new offshore patrol vessels to increase capability to undertake different roles, including enhanced border protection and patrol missions over greater distances than the existing Armidale class fleet. (Australian Government, *Defence White Paper*, 2016, p.93, available from <https://defence.gov.au/whitepaper/> [accessed 27 August 2021].) The Australian Government's 2017 *Naval Shipbuilding Plan* (p.36) stated that: 'To ensure no gap in Navy's border protection capability, the Armidale Class will be supplemented by two leased Cape Class patrol boats to support the Armidale Class remediation program and lead into the introduction of the offshore patrol vessels.'

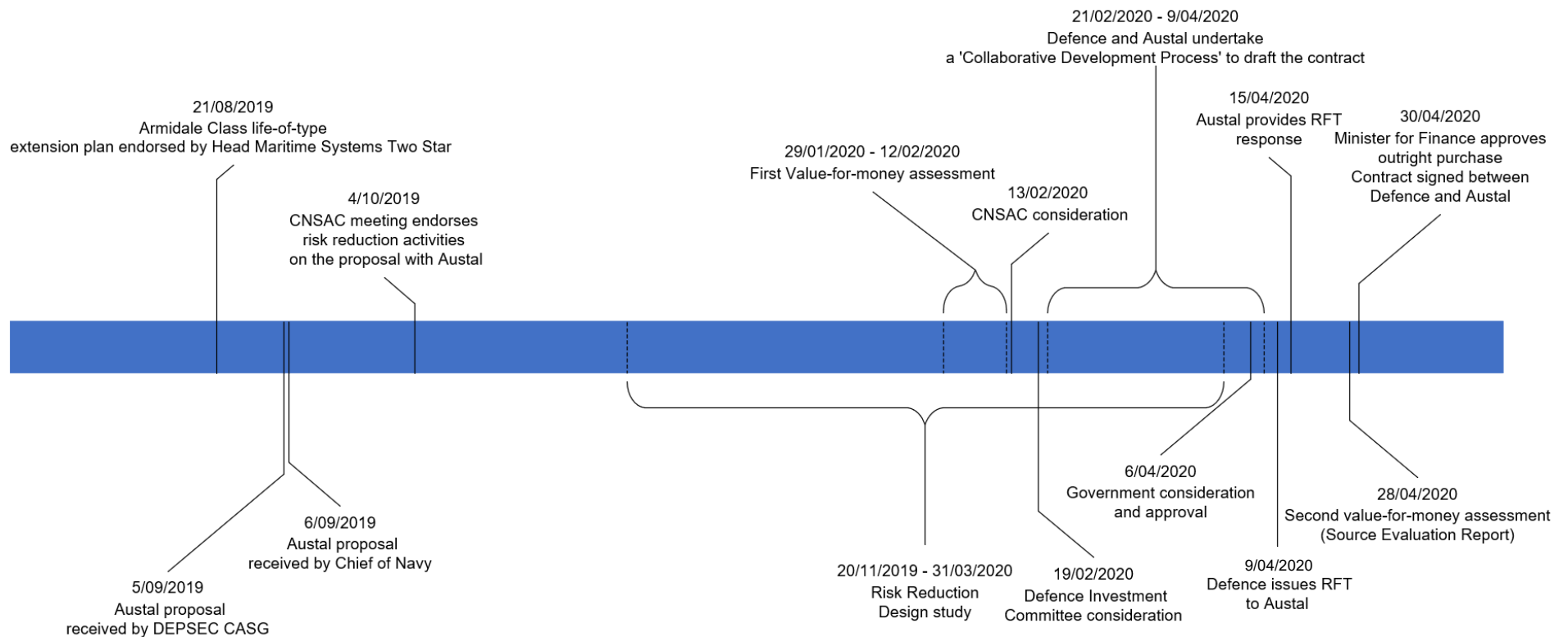
10 Defence advised the ANAO in October 2021 that: 'As the designer / builder of both the ACPB and CCPB, in addition to providing sustainment services via the extant CCPB In Service Support Contract (ISSC) and engagement for the ACPB hull remediation, Austal has a wealth of data and holds sufficient information to produce a well-developed and Unsolicited proposal to the COA [Commonwealth of Australia].'

1.8 At that time, Defence had not issued a formal request for proposal or request for tender to the market for additional Cape class patrol boats.¹¹

1.9 Following receipt of the proposal, Defence engaged with Austal through a number of activities undertaken to inform assessment of the feasibility of a possible procurement decision. These activities included a contracted Risk Reduction Design Study (from November 2019 to April 2020) and a collaborative development process (from February to April 2020). As provided for in the engagement directive setting out the parameters of the collaborative development process, a limited (sole source) Request for Tender was issued only to Austal for the procurement for six evolved Cape class patrol boats. A timeline of key activities is set out in Figure 1.1 below.

11 The Defence Procurement Policy Manual (DPPM) indicates that a proposal may be considered as unsolicited if it is received from industry when it has not been formally requested and does not fit into an existing procurement process. That is, industry has proposed a partnership, acquisition or related engagement that is not something that Defence has identified as a need or priority. In the Defence context these proposals may relate to prototype and untested technologies which industry has determined may be of interest and benefit to Defence. (Department of Defence, Defence Procurement Policy Manual, 1 July 2019, p.17, p.58). Defence advised the ANAO in October 2021 that: 'Defence (CASG) and agents therein do engage with Austal on a range of issues ... but did not seek formal advice or solicit proposals for six additional Cape Class Patrol Boats prior to the 5 September 2019 unsolicited proposal.'

Figure 1.1: Timeline of key activities for acquisition of evolved Cape class patrol boats



Source: ANAO based on Defence documents.

1.10 In announcing the acquisition, the Minister for Defence and Minister for Defence Industry stated that:

The six new Cape Class Patrol Boats will grow the patrol boat force to 16 vessels, while the new larger Arafura Class Offshore Patrol Vessels [OPVs] are introduced into service.

Minister for Defence, Senator the Hon Linda Reynolds CSC said the new vessels will play an important role in keeping Australia's borders safe, while Navy's new capability is brought online.

"These vessels will not only enhance national security, but will provide important economic stimulus and employment continuity during the COVID-19 pandemic," Minister Reynolds said.¹²

1.11 Under the contract the first evolved Cape class boat was to be delivered by Austal to Defence in September 2021, with the sixth and final hull to be delivered in March 2023. As of December 2021, Austal had not yet delivered the first boat.

1.12 The evolved Cape class fleet is a transitional capability. Defence intends the last evolved Cape class boat to be withdrawn from Navy service in July 2030, following delivery of the twelfth and final Arafura class OPV.

Design of the evolved Cape class

1.13 The 'evolved' Cape class boats are a development of the Cape class boats currently in service with Defence and the Australian Border Force.¹³ The base design was amended during the Risk Reduction Design Study process undertaken by Austal and Defence following receipt of the Austal proposal.

1.14 Defence documentation indicates that design changes were introduced to address known issues, increase the quality of life for ship's staff, manage obsolescence and mandated changes to policy, and to increase the use of Australian supplied equipment. Key design changes related to the main generator, freshwater generator, communication systems and accommodation.¹⁴

1.15 Figure 1.2 below provides a picture of the evolved Cape class boat.

12 Minister for Defence and Minister for Defence Industry, 'New patrol boats to boost Navy capability', media release, 1 May 2020, available from <https://www.minister.defence.gov.au/minister/lreynolds/media-releases/new-patrol-boats-boost-navy-capability> [accessed 18 August 2021].

13 The ANAO audited the Australian Customs and Border Protection Service's acquisition of Cape class patrol boats, including their design and build, in Auditor-General Report No.13 2014–15 *Management of the Cape Class Patrol Boat Program*, available from <https://www.anao.gov.au/work/performance-audit/management-cape-class-patrol-boat-program> [accessed 30 August 2021].

14 Appendix 3 of this report contains an overview of the general specifications of the Armidale class, the in-service Cape class and the Arafura class. The evolved Cape class boats are based on the Cape class, with defined engineering changes as discussed in paragraphs 1.13–1.14. The Risk Reduction Design Study, where engineering changes necessary were identified and agreed, is discussed at paragraphs 2.28–2.31.

Figure 1.2: Image of the evolved Cape class patrol boat



Source: Evolved Cape class patrol boat, Defence.

Project management arrangements

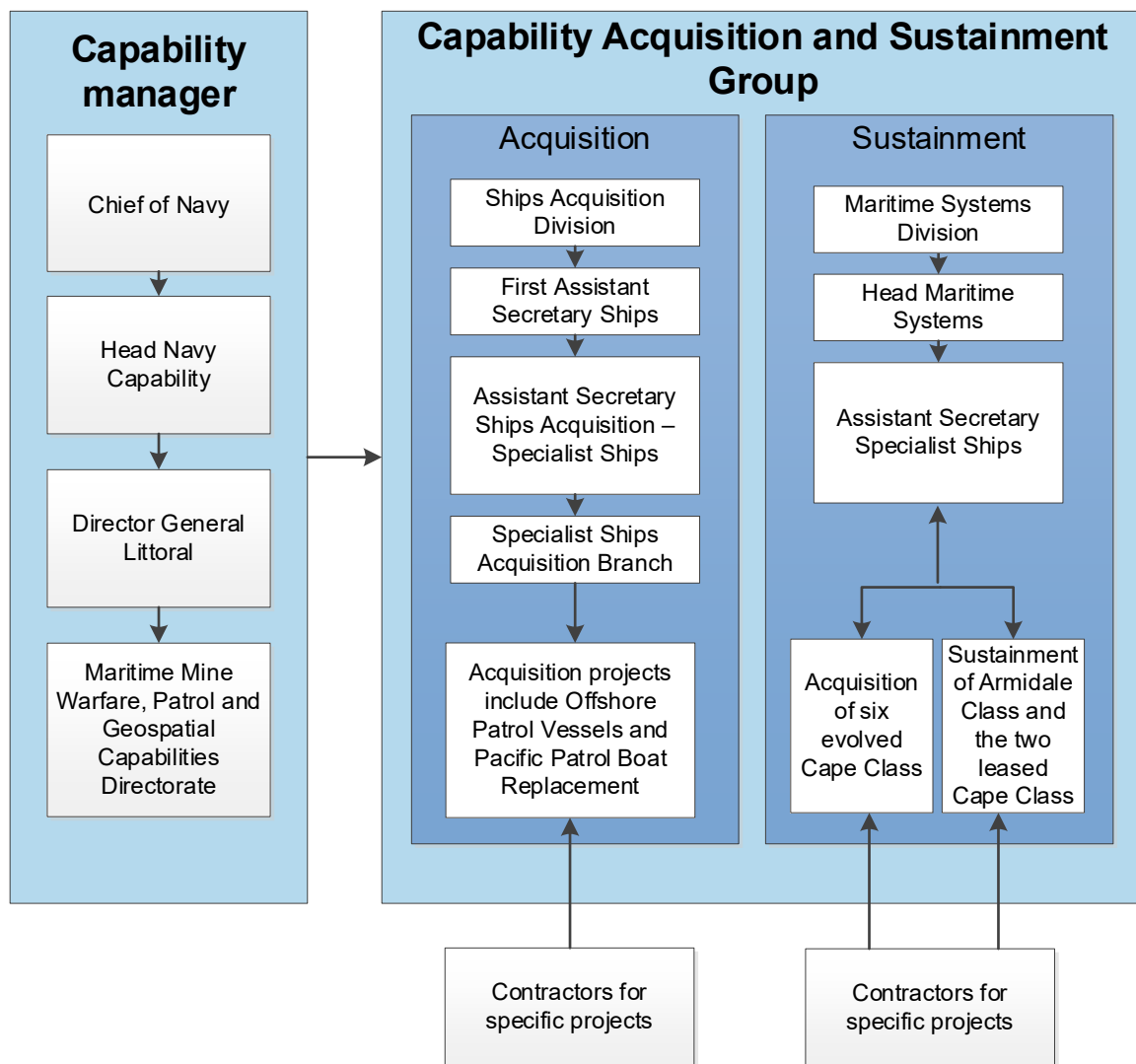
1.16 Defence's Capability Acquisition and Sustainment Group (CASG) is responsible for managing the acquisition (through project SEA 1445 Phase 1) and sustainment of the six evolved Cape class boats on behalf of Navy.

1.17 Navy is the Capability Owner and the Chief of Navy is the Capability Manager.¹⁵

1.18 Defence's high level administrative arrangements for the acquisition and sustainment of the evolved Cape class are outlined in Figure 1.3 below.

¹⁵ As the capability manager, the Chief of Navy is responsible for raising, training and sustaining capabilities as directed by the Chief of the Defence Force and Secretary of Defence.

Figure 1.3: Patrol boat acquisition and sustainment — administrative arrangements



Source: ANAO analysis of Defence documentation.

Project funding and expenditure

1.19 Defence advised the ANAO on 1 December 2021 that project funding includes: approximately \$343.9 million (2021-22 PBS out-turned price)¹⁶ as at 31 October 2021, to cover the cost of acquiring six boats; and approximately \$30.1 million to cover other costs related to the project, including approximately \$25.9 million to cover Government Furnished Equipment including seaboats.

1.20 The SEA 1445 Phase 1 (SEA 1445-1) funding covers the acquisition contract with Austal.

1.21 Additional funding to support other costs related to the project — including production monitoring and 'Required Cape Class Patrol Boat infrastructure, training, personnel,

¹⁶ Out-turning refers to applying known and expected price effects, including indexation and exchange over the life of a project to reflect that the dollar is worth less over time, providing an estimate of the real price in the out years, that is those beyond the current financial year.

communications and Fundamental Inputs to Capability'¹⁷ — is drawn from funds approved by government for the Arafura class (SEA 1180 Phase 1) transition plan and the Navy Minors Capital Program. Table 1.1 below sets out the allocated funding and actual expenditure for SEA 1445-1 as at 31 October 2021.

Table 1.1: Allocated funding and actual expenditure for acquisition of six evolved Cape class boats and associated project costs, as at 31 October 2021 (\$AUD)

Funding source	Allocated funding	Expended to October 2021	Difference
SEA 1445-1 project allocation	\$343,919,638.52	\$132,929,245.07	\$210,990,393.45
Other project costs allocation	\$30,102,499.44	\$6,253,847.51	\$23,848,651.93
Total	\$374,022,137.96	\$139,183,092.58	\$234,839,045.38

Source: Defence advice to the ANAO.

Rationale for undertaking the audit

1.22 The decision to acquire six new evolved Cape class patrol boats rather than undertake the life-of-type extension of Navy's existing Armidale class patrol boats as planned, was made following receipt of an unsolicited proposal from Austal Limited to Defence in September 2019 outlining a leasing arrangement. At the time of receipt, Defence had not planned for or approached the market for this specific capability. The audit will provide independent assurance to the Parliament of the effectiveness to date of the procurement, including Defence's assessment of value for money in the context of a sole source acquisition process.

Audit approach

Audit objective, criteria and scope

1.23 The objective of the audit was to assess the effectiveness to date of the Department of Defence's procurement of six evolved Cape class patrol boats.

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

- Did the Department of Defence (Defence) effectively assess its capability requirements and options?
- Did Defence conduct an effective procurement process that supported the achievement of its capability requirements and value for money?
- Did Defence effectively advise government?
- Has Defence established fit-for-purpose contracting arrangements for the acquisition?
- Has Defence established fit-for-purpose governance arrangements for the acquisition?

17 The transition funding allocated to support project costs includes approximately \$4.6 million for sea boats for the six ECCPBs. An additional \$4.7 million (approx.) has been reallocated from Navy Minors Capital Program funding to cover the remainder of the sea boat acquisition costs. On 30 October 2020 Defence entered into a \$10.1 million contract with Britton Maritime Systems Pty Ltd to supply 12 sea boats for the ECCPBs.

- Is Defence meeting program milestones and supporting the delivery of capability requirements?

Audit methodology

1.25 The audit procedures included:

- the review of Defence records, including advice and procurement documentation; and
- discussions with relevant Defence officials and Defence contractors carrying out similar roles.

1.26 The ANAO was unable to conduct planned fieldwork at the Henderson shipbuilding facilities in Western Australia due to travel restrictions related to the COVID-19 pandemic.

1.27 The audit was open to contributions from the public. No submissions were received.

1.28 The audit was conducted in accordance with ANAO Auditing Standards at a cost to the ANAO of approximately \$489,624.

1.29 The team members for this audit were Mark Rodrigues, Megan Beven, James Woodward, Sara Casey, Ben Thomson and Sally Ramsey.

2. Decision-making and procurement

Areas examined

This chapter examines Defence's decision-making and procurement related activities with respect to the evolved Cape class patrol boat acquisition.

Conclusion

Defence's decision-making and procurement activities were largely effective. Following receipt of an unsolicited proposal from Austal for the lease of six new Cape class patrol boats in September 2019, Defence effectively assessed its capability requirements and options. Defence's subsequent sole source tender was largely effective and supported the achievement of value for money and Defence's capability requirements. Defence did not assess potential probity risks on receipt of the unsolicited proposal or introduce additional arrangements to manage probity risk until exclusive negotiations commenced in February 2020. Defence's advice to government was largely effective, although it could have been more clearly presented.

Areas for improvement

The ANAO made one suggestion that Defence improve clarity and transparency regarding the handling of unsolicited proposals received by Defence.

The ANAO made one recommendation aimed at the development and implementation of specific requirements for the management of probity when engaging with industry on unsolicited proposals.

2.1 Paragraph 2.7 of the April 2019 and December 2020 *Commonwealth Procurement Rules* (CPRs) defines procurement as:

... the process of acquiring *goods* and services. It begins when a need has been identified and a decision has been made on the procurement requirement. *Procurement* continues through the processes of risk assessment, seeking and evaluating alternative solutions, and the awarding and reporting of a *contract*.

2.2 Paragraph 35 of the July 2019 Defence Procurement Policy Manual (DPPM)¹⁸ stated that:

The DPPM provides a framework that promotes responsible and accountable spending by Defence officials when procuring goods and services for Defence. This framework supports the proactive management of the risks relating to procurement, as required by the CPRs.

2.3 Paragraph 4 of the July 2019 DPPM further stated that:

The DPPM incorporates both the CPRs and additional Defence Procurement Policy Directives that must be complied with by Defence officials in relation to procurement. Defence Procurement Policy Directives supplement specific CPRs in the context of the particular circumstances and needs of the Department of Defence ('Defence').

2.4 Following receipt of an unsolicited proposal from Austal Limited (Austal) on 5 September 2019 for the lease of six Cape class patrol boats and assessment of the feasibility of the proposal, on 6 April 2020 the Australian Government decided to acquire six evolved Cape class patrol boats from Austal.

18 This is the version of the DPPM applying to the events reviewed as part of this audit. The DPPM was updated in February 2021.

2.5 This chapter considers Defence's decision-making and advice in relation to the procurement of the evolved Cape class, focusing on whether Defence: effectively assessed its capability requirements and options; conducted an effective procurement process that supported the achievement of its capability requirements and value for money; and effectively advised government. The ANAO examined Defence's:

- application of DPPM guidance in its assessment of the unsolicited proposal from Austal;
- assessment of value for money — in particular, whether the mandatory requirements in the CPRs and DPPM for the assessment of financial and non-financial costs and benefits and the benefit to the Australian economy were undertaken, and documented, to demonstrate value for money;
- management of probity — in particular, whether Defence established and implemented appropriate arrangements to effectively manage probity risks in the context of its consideration of the unsolicited proposal and its procurement process; and
- advice to government regarding the unsolicited proposal, the assessment processes undertaken and the rationale for recommending this acquisition rather than proceeding with the planned life-of-type extension (LOTE) for Navy's existing Armidale class patrol boats.

Did Defence assess the proposal received in accordance with the Defence Procurement Policy Manual requirements?

Defence assessed the unsolicited proposal received from Austal largely in accordance with the Defence Procurement Policy Manual (DPPM) requirements, which incorporate the Commonwealth Procurement Rules (CPRs). To improve clarity and transparency regarding the handling of unsolicited proposals received by Defence, there would be merit in Defence clarifying the procedures to be applied by officials handling unsolicited proposals. Defence applied a series of processes to assess and develop the proposal, including a Risk Reduction Design Study. A limited tender (sole source) Request for Tender process was conducted based on the exemption under paragraph 2.6 of the CPRs, and the basis for exemption from the competition requirements of the CPRs was documented. Defence did not prepare a written procurement plan as required under the DPPM for procurements valued at or above \$200,000.

Receipt of the proposal

2.6 Austal sent (by email) an unsolicited proposal dated 5 September 2019 to the Deputy Secretary, Capability Acquisition and Sustainment Group (CASG) and also to the Chief of Navy on 6 September 2019.

2.7 Box 1 (below) sets out available guidance for the management of unsolicited proposals by the Department of Finance (the policy owner of the Commonwealth's procurement policy, the Commonwealth Procurement Rules, or CPRs) and Defence (owner of the Defence Procurement Policy Manual, or DPPM).

Box 1: Guidance for managing unsolicited proposals

The Commonwealth Procurement Rules do not differentiate between solicited and unsolicited proposals until the procurement method is considered, at which point they note that a procurement above the relevant threshold can be conducted by limited tender for procurements made under exceptionally advantageous conditions that arise only in the very short term, such as from unsolicited innovative proposals.^a

The Department of Finance's (Finance) guidance on selling to government^b states that:

The Commonwealth Procurement Rules govern how entities buy goods and services, and are designed to ensure the Government and taxpayers get value for money.

With regard to unsolicited proposals, the guidance states that:

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

The Unsolicited Proposals Gateway referred to in the Finance guidance is no longer available.^c

The 1 July 2019 Defence Procurement Policy Manual (DPPM)^d includes four references to unsolicited proposals. The first three references are set out in paragraphs 41–43 of the DPPM, which discuss unsolicited innovative proposals in the context of making a decision to use the limited tender procurement method, but do not define what is meant by 'innovative' in this context. These paragraphs state that:

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

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

While Defence business units should be open to receiving and considering unsolicited innovative proposals from industry, Defence has also put in place a formal mechanism to manage these

kinds of proposals from industry. This is the Centre for Defence Industry Capability (CDIC) which hosts the Defence Innovation Portal, the primary gateway for companies seeking to submit innovation proposals or ideas to the Defence Innovation Hub and Next Generation Technology Fund.

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

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

Note a: Australian Government, Department of Finance, *Commonwealth Procurement Rules*, 14 December 2020, paragraph 10.3.

Note b: See: <https://sellingtogov.finance.gov.au/guide/identifying-opportunities-to-sell-to-government> [accessed 27 August 2021].

Note c: See: <https://sellingtogov.finance.gov.au/guide/identifying-opportunities-to-sell-to-government> [accessed 27 August 2021]. The Finance guidance refers interested parties to a website that is associated with the Defence Materiel Organisation (DMO). DMO became the Capability Sustainment and Acquisition Group within the Department of Defence in 2015.

The Department of Defence's website refers potential sellers back to the guidance from Finance and to 'Defence and the Private Sector – an ethical relationship', the link to which is also no longer valid. On the 'Defence Procurement Policy' page, Defence advises that it is updating the guidance on selling to Defence. See: <https://www1.defence.gov.au/business-industry/procurement/policies-guidelines-templates/defence-procurement-policy> [accessed 27 August 2021].

Note d: As discussed in paragraph 2.3, paragraph 4 of the 1 July 2019 DPPM informed Defence officials that it incorporated both the CPRs and additional Defence Procurement Policy Directives that must be complied with by Defence officials in relation to procurement. The directives supplement specific CPRs in the context of the particular circumstances and needs of Defence.

2.8 In August 2021, Defence advised the ANAO that it did not refer Austal's unsolicited proposal to the Centre for Defence Industry Capability (CDIC)¹⁹, which was the 'primary gateway' identified in the July 2019 DPPM. Defence was unable to provide contemporaneous documentation outlining why the process for unsolicited innovative proposals described in the DPPM did not apply to the Austal proposal. Defence advised the ANAO on 1 October 2021 that:

Defence notes that there were no mandatory requirement[s] in the DPPM requiring officers to handle unsolicited proposals in a specific manner (including sending unsolicited proposals through CDIC).

2.9 Defence also advised the ANAO that receiving unsolicited proposals is:

... a natural part of Defence's interaction with its Industry Partners as Fundamental Input to Capability who are continually looking at innovative ways to better support the ADF.

2.10 In November 2021, the Secretary and Chief of the Defence Force advised the ANAO that:

... Defence contends that the procedural pathway referred to is for 'unsolicited *innovative* proposals, of which this proposal was not one' (emphasis in original).

19 On 26 November 2021 the Minister for Defence Industry announced the launch of the new Office of Defence Industry Support, which replaces the Centre for Defence Industry Capability as the primary interface between Defence and defence industry. See: <https://www.minister.defence.gov.au/minister/melissa-price/media-releases/office-defence-industry-support-open-business> [accessed 7 December 2021].

2.11 While the procedural pathway for unsolicited innovative proposals referred to by the Secretary and Chief of the Defence Force is outlined in the DPPM, the DPPM does not provide a definition of ‘innovative’ or ‘unsolicited innovative proposal’ to aid decision-making for handling unsolicited proposals. The DPPM is couched in more general terms, stating that innovative proposals may include something that Defence has not identified as a current need or priority but which nonetheless offers value to Defence, as noted in Box 1 (above). This is consistent with the situation described in paragraph 1.1 to 1.3. Defence had developed a plan to undertake a LOTE of the Armidale Class Patrol Boats and had not identified the lease or procurement of additional Cape Class Patrol Boats to support transition to the Offshore Patrol Vessel (OPV). Nonetheless, Defence saw value in Austal’s unsolicited proposal.

2.12 To improve clarity and transparency regarding the handling of unsolicited proposals received by Defence, there would be merit in Defence clarifying the procedures to be applied by officials handling unsolicited proposals.

Initial consideration of the proposal

2.13 During the remainder of September 2019 Defence actively explored options to provide support to Austal, including the option outlined in the unsolicited proposal.²⁰ Defence records from that time indicate that Defence understood that Austal had told the Australian Government that unless it received more work from Defence it would make hundreds of workers redundant over the next 6–12 months.²¹ Both the Minister for Defence and the Minister for Defence Industry were made aware of the Austal proposal, with the Minister for Defence Industry meeting with Austal on 25 September 2019 to discuss the proposal.

2.14 By 26 September 2019, the lease of six additional Cape class patrol boats was considered a ‘live option’ within Defence, and it was decided to present this alternative proposal at the Chief of Navy Senior Advisory Committee (CNSAC) on 4 October 2019. It was expected that by the time of the CNSAC meeting, Defence would have a ‘medium level of fidelity’ of the issues and opportunities of this option in comparison to the planned Armidale class LOTE.

2.15 On 3 October 2019, CNSAC members were advised that:

The agenda paper previously submitted on the ACPB LOTE [Armidale class patrol boat life-of-type extension] Project Execution Strategy will be tabled as read, and the presentation of the link [ie. analysis of the Austal proposal] presented instead.²²

2.16 CNSAC received a presentation on 4 October 2019 which outlined:

20 Defence records from September 2019 indicate that in addition to the unsolicited proposal, a number of alternative options were also considered by Defence: ‘Sole source Austal to build-to-print a simple landing craft to be gifted to Pacific Island nations’; ‘Sole source Austal to design and build a Large Hulled Vessel for the SWPAC step up’; ‘Sole source Austal to build-to-print a vessel like Ocean Protector’; and ‘Bring forward and sole source LAND 8710, Army landing craft, to Austal’.

21 Defence records indicate that redundancies were planned at the Henderson shipyard in Western Australia after Austal made a business decision not to build any more commercial ferries in Australia, with future ferries to be built in Vietnam and the Philippines.

22 ANAO comment: the LOTE Project Execution Strategy had been provided to CNSAC members on 23 September 2019 for endorsement at its meeting of 4 October 2019, in accordance with an April 2019 CNSAC decision. The paper to CNSAC noted that the Armidale class LOTE Strategy ‘will support an evidence based risk management approach to support capability decisions as required to ensure the risk of a capability gap is mitigated during the transition to the Aradara Class vessels’.

... the Austal proposal for Navy to acquire and double-crew six CCPBs [Cape class patrol boats] as a feasible alternative transition plan, and seek CNSAC agreement to proceed with further risk reduction activities.

2.17 The presentation recommended that CNSAC:

Agree that the Austal proposal is a feasible alternative transition strategy that may cost-effectively improve Patrol Force reliability by reducing the average vessel age profile.

2.18 CNSAC noted that the proposal: was affordable (noting that a leasing arrangement had been put forward); may need additional build requirements to provide the capability required²³; and was 'highly ambitious' in terms of the timeline. In particular, CNSAC noted that risk reduction activity would have to 'proceed now in order for Government approval in December, for Austal to proceed in mid-2020, as they will need to purchase long-lead items in early 2020'.²⁴ The rationale for Defence decision-making to be driven by Austal's timeline was that:

If Austal are informed Navy are considering the offer they will also be able to maintain their workforce; otherwise they would soon commence downsizing (down to 200 from 700).

2.19 On the basis of the advice and presentation provided at the meeting, CNSAC agreed:

- That the Austal proposal was a feasible alternative transition strategy which may cost-effectively improve Patrol Force reliability by reducing the average vessel age profile.
- To proceed with planned maintenance of three of the Armadale class patrol boats.
- To proceed to Gate Zero²⁵ in November 2019, with risk reduction activities to be conducted in November 2019 – January 2020 to confirm the risk/reward profile.

2.20 The presentation to CNSAC and the meeting minutes did not document the cost of the Austal proposal, compare it to the cost of the planned Armadale class LOTE, or outline Defence's consideration of alternative options.²⁶ The basis on which CNSAC considered the cost of the Austal option to be viable was not documented.²⁷ Defence advised the ANAO in October 2021 that:

Early costings and value for money work was conducted from receipt of the unsolicited proposal. The cost comparison was provided (though incomplete and immature) for CNSAC to consider the

23 Defence records indicate that in late September 2019 CASG considered that 'While CCPB [Cape class patrol boats] support constabulary operations, they are less suited to other ACPB [Armadale class patrol boat] roles'.

24 Activity under the previously approved transition plan, including planning in relation to Armadale class LOTE activity continued to be undertaken in parallel to consideration of the impacts and feasibility of the Austal proposal. Defence advised the ANAO that: 'Speed in decision making was required to turn off the ACPB LOTE planning activities at the penultimate phase of this work (effort, engineering and expenditure) by the PB SPO and ACPB In Service Support contractor.'

25 Gate Zero is the decision point at which the Defence Investment Committee considers an investment proposal developed by a Capability Manager, in this case the Chief of Navy. It may agree to a proposal to develop a range of options with agreed timeframes, requirements and financial commitments to proceed to a Gate 1 decision by government, or agree a single option for accelerated movement directly to Gate 2 decision by government.

26 The Austal proposal contained limited financial information. Prior to the October CNSAC meeting, Defence had commenced a review of Austal's costings, informed by additional information provided by Austal. The initial assessment estimated the savings from implementing the Austal proposal (without undertaking Armadale class LOTE activities) to be \$328,799,416. The CNSAC meeting papers did not refer to the outcome of this review.

27 Defence informed the ANAO that its assessment of the Austal proposal against its capability requirements was also informed by its knowledge of the boat based on its previous assessment of the Cape class in 2015 and its ongoing lease of two Cape class patrol boats. In 2015, in preparation for hull remediation of the existing Armadale class fleet, Defence had considered two options for supplementing the Armadale class capability: the Damen modified FCS 5009 and the Austal Cape class.

unsolicited proposal in context. It was noted at the time that a series of feasibility studies would be required to refine the cost estimate, the program of work and the price point for the new Capes to inform any acquisition decision.

2.21 On 16 October 2019 the Defence Investment Committee received a verbal brief on the Austal proposal from the Director-General Littoral. The Chair noted that:

Clear recommendations that are focused on the capability, must be presented to avoid a reduction in platforms that result in a reduced level of capability.²⁸

2.22 On 21 October 2019, the Deputy Secretary CASG wrote to Austal to advise that:

... the Cape class lease proposal is of genuine interest to Defence. I have directed my team to work collaboratively with you to explore in detail the feasibility of the Cape class lease proposal. To this end, you can expect a restricted Request for Tender will be issued to Austal for a Cape class Risk Reduction Design Study (RRDS).

2.23 CASG's Specialist Ships Branch utilised an existing contract provision — specifically the Survey and Quote clause in its in-service support contract for the two Cape class patrol boats in Navy service — to sole-source Austal to undertake a risk reduction design study (RRDS). The study is discussed from paragraph 2.28 below. The advice provided to the section 23 commitment approval delegate²⁹ (the Patrol Boat Sustainment Program Office Director) stated that:

The procurement method to be utilised for this task is via the Survey and Quote provisions of Reference A [the existing Cape class sustainment contract] utilising pre-approved labour rates and contract conditions which have been previously assessed as providing value for money.

The contractor is the Original Equipment Manufacturer and thereby enables the Commonwealth to leverage on the knowledge and expertise of the contractor in the RRDS [risk reduction design study]. However, as the procurement method is sole source utilising the S&Q [survey and quote] provisions of the existing ISSC [in-service support contract], the market has not been tested and it is unknown whether there are other players in the market who may be able to provide these services.

The Chief of Navy Senior Advisory Committee have reviewed the proposal submitted by the OEM [original equipment manufacturer] and have requested the RRDS to provide insight for further review to be conducted in February 2020 before a decision is made as to whether to progress the proposal.

2.24 Defence advised the ANAO in October 2021 that:

This is considered an appropriate process. The use of S&Q as the mechanism for the engagement for the completion of the RRDS significantly reduced the administrative overhead. The engagement de-risked the CoA [Commonwealth of Australia] by leveraging already proven value for money extant terms and conditions via the negotiated and agreed ISSC contract.

28 The Committee resolved that: 'CN [Chief of Navy] to advise on an appropriate date to return to the Committee, by 20 November 2019, on the Austal Cape Class Patrol Boat Lease Proposal, after the completion of risk reduction activities'.

29 In Defence, a section 23 commitment approval documents the exercise of delegated authority to commit relevant money (i.e. public money) under subsection 23(3) of the *Public Governance, Performance and Accountability Act 2013* (Cth).

2.25 Approval to adopt a sole source procurement approach for the RRDS was provided by the Assistant Secretary, Specialist Ships on 1 November 2019.³⁰ The Endorsement to Proceed was endorsed by the Patrol Boat Sustainment Program Office Director on 6 November 2019.

2.26 The total estimated value of the RRDS related procurements was \$3.3 million. This included \$2.2 million for Austal to undertake RRDS work, and \$385,000 in funding for Australian Maritime Technologies (AMT) to verify Austal's RRDS work.³¹ The delegate was advised that the value of the engagement was a 'ROM [rough order of magnitude] costing developed during a preliminary meeting to develop guidelines for the RRDS involving Defence Finance Group, Navy, PBSPO [Patrol Boat Systems Support Office] and the OEM [original equipment manufacturer] (Austal)'. The section 23 commitment approval was signed by the delegate on 14 November 2019.

2.27 The objective and conduct of the RRDS is discussed below. While Austal's September 2019 proposal related specifically to the lease of Cape class boats, the subsequent Defence review processes also considered other options, which were presented for government consideration in April 2020. The government agreed in April 2020 that the Ministers for Defence and Finance would determine the appropriate funding method — either to lease, purchase outright, or a combination of both by exchange of letters. On 30 April 2020 the Minister for Finance wrote to the Minister for Defence agreeing to the purchase of six evolved Cape class patrol boats from Austal.

Risk Reduction Design Study (RRDS)

2.28 The objective of the RRDS was to identify all deviations from the extant Cape class patrol boat design, provide impact assessments of those deviations, develop ship design documents including system specifications, and develop lifecycle upkeep and sustainment intelligence system specifications. These deviations included modifications to the extant design to address known deficiencies in the extant Cape class design which had previously resulted in sustainment issues. Defence's RRDS activities were primarily conducted in the period 1 December 2019 to 31 March 2020.

2.29 Austal's summary report of its RRDS deliverables³² covered 20 impact assessments including generator, sewage treatment system, davit³³, external paint and lighting changes, 17 of which were approved and included in the acquisition contract for progression to engineering change proposals.³⁴ In aggregate, Austal's report noted that there would be no reduction in capability over that provided by the extant Cape class boats, with speed, range and endurance unchanged. Austal's summary report also noted that it had 'successfully delivered the requirements of the RRDS to the Commonwealth as per the Statement of Work'.

2.30 AMT's closing report on the RRDS (dated 9 April 2020) found that, compared to the RRDS Statement of Work, Austal had not provided four out of seven major design documents at the

30 As discussed in footnote 6, Defence relied on paragraph 2.6 of the CPRs to conduct a sole source procurement process. The core principle of the CPRs, the achievement of value for money, continued to apply.

31 AMT was engaged via a panel for this purpose.

32 Austal prepared reports summarising the outcomes of the RRDS process which it provided to Defence on 21 January 2020 and 27 March 2020.

33 'Davit' refers to various crane-like devices used on a ship for supporting, raising and lowering equipment such as boats and anchors.

34 Approved engineering changes are discussed in this report at paragraph 3.20.

completion of the RRDS, with a fifth partially provided.³⁵ AMT also identified eleven key risks and issues that were outstanding at the completion of the RRDS.³⁶ The ANAO did not find evidence that the AMT report contributed to the decision-making process for the evolved Cape class procurement.

2.31 The collaborative development process is discussed below.

Collaborative Development Process (CDP)

2.32 The Austal proposal was considered at CNSAC on 13 February 2020 and Defence's Investment Committee on 19 February 2020. Both committees recommended that the proposal proceed, and that a contract for the acquisition of six evolved Cape class boats be collaboratively developed with Austal for delegate consideration.³⁷

2.33 On 21 February 2020, the delegate (Assistant Secretary Specialist Ships) issued an engagement directive instructing the Project Director SEA 3036 to undertake a Collaborative Development Process (CDP) with Austal.³⁸ The directive outlined that the collaboratively developed acquisition contract was to be funded through a finance arrangement with a finance institution and a charter back to the Commonwealth.³⁹

2.34 The engagement directive also set out: high-level principles to guide the process; procedures for referral of issues to the delegate; probity arrangements⁴⁰; and issues for negotiation.

2.35 The CDP was intended to cover the following matters:

- development of the draft contract;
- dialogue regarding the commercial principles to underpin the contract and the program;
- formal acknowledgement of the commercial principles and the baseline scope of work;

35 AMT's closing report stated that Austal had not completed all of its deliverables under the RRDS. The report indicated that key documents not provided by Austal were: a Requirements Traceability Matrix (RTM) for the Evolved Ship Specification; a Master Equipment List (MEL) based on updated System Specification; Summary of Changes Document; and a consolidated list of certification requirements for each deviation. Supporting technical documentation for each Impact Assessment was partially provided. The closing report was provided after Defence sought government approval to issue a Request for Tender to Austal. Defence advised the ANAO in December 2021 that the fifth partially provided major design document was partially provided 'due to the continued development of the Engineering change Proposal (ECP) required.'

36 Defence advised that 'On completion of the RRDS, the AMT engagement was continued under the acquisition project to provide continuity in the development of the engineering changes and provide the verification and validation of the outstanding RRDS enhancements.'

37 While the February 2020 value for money assessment of the Austal proposal assessed the proposal as if it were a direct purchase, CNSAC and the Investment Committee considered it as a finance lease arrangement.

38 The engagement directive noted that: 'The schedule for the Evolved Cape Class Patrol Boat Program is aggressive. As outlined in the Endorsement to Proceed ... it is considered that the most effective way to reach agreement with Austal on key commercial issues and to develop a draft contract within the schedule is through a Collaborative Development Process (CDP), which is the subject of this Directive.' The directive also noted that, 'Delegate approval and Government support will be required prior to execution of the collaboratively developed acquisition contract.'

39 The section 23 commitment approval for the procurement of six evolved Cape class patrol boats noted that the 'Contract caters for the lease in all relevant commercial aspects, as was directed, however but does not need to be amended to return to a traditional purchase'.

40 Defence's management of probity during the CDP is examined below at paragraphs 2.89–2.93.

- issue of a draft contract, statement of work and attachments to Austal for a tender response; and
- post evaluation negotiations if needed.

2.36 The process was to be conducted with Austal ‘flexibly, using a combination (as required) of face to face workshops, teleconferences, video conferences, email correspondence and formal letters’.

Addressing the Commonwealth’s key negotiation outcomes

2.37 The engagement directive set out 20 key negotiation issues to be addressed during the development of the contract for procurement. These related to: pricing; performance guarantees; risk mitigation costs; defect notification and rectification; intellectual property; insurance⁴¹; requirements verification; liquidated damages; limitation of liability; and Australian Industry Content. Of the 20 delegate-approved negotiation issues, Defence achieved the Commonwealth’s preferred position on 13 issues and the minimum fallback position on six issues. For the remaining issue Defence did not document the Commonwealth’s preferred and minimum fallback positions.⁴²

2.38 Consistent with the DPPM guidance that Defence officials should seek specialist contracting or legal advice before accepting an unsolicited proposal, Defence sought internal and external legal advice on specific aspects of the draft contract, including additional clauses proposed during negotiation.

Request for Tender (RFT)

2.39 During the CDP, in March 2020, Defence sought government approval to implement the revised Offshore Patrol Vessel (OPV) Transition Plan, including through the construction of six new Cape class patrol boats by Austal. The government agreed to the acquisition and associated OPV transition planning on 6 April 2020, with the funding method to be agreed between the Ministers for Defence and Finance.⁴³ The revised OPV transition plan did not include a LOTE for the Armidale class patrol boats.

2.40 A Request for Tender (RFT) was issued solely to Austal on 9 April 2020, for the procurement of six evolved Cape class patrol boats and associated supplies. The RFT included the draft contract (as developed through the CDP) as an attachment and Austal was asked to provide a tender response by 11 PM on 15 April 2020, including all items set out in the attached tender data requirements list. Austal submitted its response to the RFT on 15 April 2020.

41 In relation to insurance, Defence’s preferred negotiation outcome was to consider using the Maritime Insurance Program (MIP) if achievable in the CDP timeframe and if it would result in cost savings in the contract, with remaining insurances to be taken out by Austal. Negotiating MIP arrangements was ‘hindered’ by the fact that Austal had taken out shipbuilder’s insurance and commenced production prior to provision of MIP indicative costings. The section 23 commitment approval asked the delegate to consider directing the Defence contract manager to explore options for implementing elements of the MIP through contract change.

42 The issue was in relation to tailoring of validation and verification requirements under the statement of work in order to make clear the scope of verification applicable to items changed as part of the RRDS changes to the baseline for Capes 9 and 10.

43 The advice provided to government is discussed further in paragraphs 2.94–2.102. The ministers were to agree to a finance lease, a direct purchase, or a combination of the two, as noted at paragraph 2.27.

Assessment of the Tender

2.41 The Tender Evaluation Plan (signed by the Assistant Secretary Specialist Ships on 15 April 2020) set out the evaluation criteria that were subsequently used to assess Austal's tender response, as well as an evaluation methodology to assist the Tender Evaluation Board (TEB) to assess the tender deliverables against the criteria.

2.42 The criteria related to: the suitability of the tenderer to perform the obligations in the draft contract; the extent to which the tendered solution was capable of meeting end user and capability needs and other requirements; the extent to which the tenderer was assessed as being able to deliver the supplies; tendered prices and pricing structure; and the extent to which the tender satisfied the commercial requirements of the draft contract and the assessed risks of entering into a contract with the tenderer.⁴⁴

2.43 The evaluation methodology included guidance on assigning compliance ratings to Austal's response as a whole and deficiency ratings to any part of the tender assessed as non-compliant against a requirement of the request documentation. The methodology also set out that a risk assessment would be applied to each criterion addressing the level of confidence of the Tender Evaluation Organisation members conducting the evaluation, with confidence indicative of an assessment of risk associated with the tender, and an overall risk assessment prepared for the Source Evaluation Report.

2.44 Defence did not develop a written procurement plan, which was a requirement under the DPPM for procurements valued at or above \$200,000.⁴⁵ Defence advised the ANAO in October 2021 that:

Defence considers that this requirement had been met through the Endorsement to Proceed (ETP) submission which included the proposed procurement approach and justification for the proposed approach.

2.45 Defence further advised the ANAO in December 2021 that:

Defence met the intent of this Defence Procurement Policy Manual (DPPM) requirement through the Endorsement to Proceed (ETP) approval which included relevant procurement planning considerations including the proposed procurement method, CPR 2.6 justification and how the intended procurement would achieve value for money. Defence considered the ETP to be commensurate planning documentation for the scale, scope and risk for this procurement.

44 The criteria and subsequent source evaluation report which documented Defence's evaluation against the criteria did not include consideration of the Commonwealth's experience in acquiring Cape class patrol boats for the Australian Border Force. Auditor-General Report No.21 2018–19 *Cape Class Patrol Boat — In Service Support Arrangements*, noted a range of final acceptance issues in the Department of Home Affairs' acquisition of eight Cape class boats, including capability (vessel performance) and support system defects and deficiencies. The audit report, which tabled on 18 December 2019, noted that as at October 2018, the fleet had not been finally accepted, capability and support system deficiencies remained, and the project had not successfully transitioned to the in-service support phase. As discussed at paragraphs 2.28 to 2.31, defects and deficiencies in the extant Cape class patrol boat design as at 1 November 2019 were addressed through RRDS impact assessment items. Accordingly, the assessment of risk in the tender evaluation process represented the risk profile of entering into contract with Austal for the delivery of the evolved Cape class design incorporating these items.

45 The DPPM in effect at that time required 'Defence officials undertaking procurement valued at or above \$200,000 (including GST) to develop a written procurement plan for the procurement commensurate with its scale, scope and risk, and which takes account of the procurement life cycle, including cost of ownership and disposal considerations.'

2.46 Defence undertook a procurement risk assessment and developed a risk management plan as required by the DPPM. The initial risk assessment took the form of identifying (in the value for money assessment) three key risks.⁴⁶ These risks were assigned ratings and mitigations were recommended to the delegate. The risks were retired in the Source Evaluation Report (discussed below), which included an assessment of risk against the evaluation criteria set out in the Tender Evaluation Plan. A liability risk assessment, which included other procurement risks — such as Austal not completing the contract or completing it late, and the supplies not meeting Defence requirements — was also undertaken to inform liability caps in the contract.

Source Evaluation Report (SER)

2.47 The Tender Evaluation Board's (TEB's) assessment of Austal's tender response was documented in a Source Evaluation Report (SER). The SER was finalised, endorsed by the Chief Contracting Officer, Materiel Procurement Branch Ships and Maritime, and signed by the delegate (Assistance Secretary Specialist Ships) on 28 April 2020.

2.48 The TEB concluded that the evaluation conducted to that date indicated that Austal met the requirements for the subject procurement activity and represented value for money for the Commonwealth (discussed further below). The TEB recommended that Austal continue to be engaged under the CDP in relation to the RFT and that the Commonwealth finalise negotiations with Austal to enable consideration of a section 23 commitment approval by the delegate.⁴⁷

2.49 The TEB assessed Austal's RFT response as overall meeting Defence's requirements, with medium risk. Overall compliance with the evaluation criteria was assessed as:

... having a 'cumulative' level of deficiencies without substantial implications for the requirements, and therefore may be acceptable without all proposed remedial actions being successfully undertaken.

2.50 The TEB also noted that:

As Navy has confirmed that the operational needs are satisfied by the Reference Ship and directed RRDS changes, all of which have been embodied within the Contracted Description of Requirement, there remains low risk that the tendered solution will materially affect performance requirements for the ECCPB [Evolved Cape Class Patrol Boats] to the extent that the operational capability needs will be impacted.⁴⁸

Section 23 commitment approval

2.51 Following government approval to proceed with the acquisition on 6 April 2020, a section 23 commitment approval was signed on 29 April 2020 by the Assistant Secretary Specialist Ships,

46 These risks pertained to misalignment of understanding of scope between Defence and Austal in relation to the proposal; foreign exchange fluctuations that might fall to the Commonwealth if a finance lease was used rather than a direct purchase to fund the acquisition; and whether to implement a performance guarantee by way of surety for performance.

47 Defence's letter to engage Austal on the CDP noted that Austal's participation in the CDP was at its own cost and risk.

48 Defence advised the ANAO on 1 October 2021 that, 'Whilst not in document form, interaction with numerous Navy personnel prior to and during RRDS (including a DGLITTORAL-assigned Navy representative) confirmed overall satisfaction with the Reference Ship, together with improvement paths, which fed into RRDS scoping and modification selections.' [DGLITTORAL is Defence's Director-General for littoral ships].

approving the commitment of \$438,112,734 (GST inclusive).⁴⁹ The CDP outcomes were documented in a spreadsheet setting out the results of the negotiation and provided to the delegate as an enclosure to the section 23 commitment approval.⁵⁰

2.52 Funding was approved for the cost of the acquisition contract with Austal for six evolved Cape class boats and associated supplies, but not for project office activities, project contingency, Government Furnished Equipment or any other funding requirement.⁵¹

2.53 Defence signed a contract with Austal for the acquisition on 30 April 2020.

Did Defence appropriately assess value for money in the context of a sole source procurement?

Defence's assessment of value for money of Austal's sole source tender was largely appropriate. In the absence of market testing, Defence relied on its benchmarking of Austal's costs with internally held information on Cape class costs acquired by Defence as part of the leasing arrangements for two Cape class patrol boats in Navy service, and information gathered in the context of planning the Armidale class life of type extension. Key decision documents did not include a cost comparison or document consideration of the Australian Customs and Border Protection Service's earlier acquisition of eight Cape class patrol boats for the Commonwealth.

2.54 Paragraphs 6 and 7 of the DPPM state that:

Division 1 of the CPRs (in Chapter 4 of the DPPM) sets out rules that apply to all procurements. This means that all Defence procurements are required to comply with Division 1 (and the additional Defence Procurement Policy Directives in Chapter 4 of the DPPM). This Division establishes 'value for money' as the core requirement of Commonwealth procurement. Defence officials responsible for a procurement need to be satisfied, after reasonable inquiries, that the procurement achieves value for money.

Division 1 provides a framework for determining 'value for money'. Under this framework, procurements should: encourage competition and be non-discriminatory; use public resources in an efficient, effective, economical and ethical manner that is not inconsistent with the policies of the Commonwealth; facilitate accountable and transparent decision making; encourage appropriate engagement with risk; and be commensurate with the scale and scope of the business requirement. [emphasis in original]

49 The section 23 commitment approval value did not reflect the actual or expected contract value for the acquisition. An administrative error resulted in the commitment approval being for \$71,385,595.79 more than required.

50 The section 23 commitment approval was signed by the delegate on 29 April 2020.

51 The section 23 commitment approval outlined that Austal had commenced production during contract negotiations at its own risk. Austal commenced production on 6 April 2020.

2.55 In assessing the proposal from Austal, Defence officials were required to give consideration to the relevant financial and non-financial costs and benefits in determining whether it represented value for money, including but not limited to⁵²:

- a. the quality of the goods and services;
- b. fitness for purpose of the proposal;
- c. the potential supplier's relevant experience and performance history;
- d. flexibility of the proposal (including innovation and adaptability over the lifecycle of the procurement);
- e. environmental sustainability of the proposed goods and services (such as energy efficiency, environmental impact and use of recycled products); and
- f. whole-of-life costs.

2.56 In the context of these requirements, the ANAO examined Defence's documentation that set out how value for money was assessed for the Austal proposal. Defence assessed the proposal as a direct purchase acquisition rather than a lease as originally proposed by Austal, based on the direct purchase cost information provided by Austal.

2.57 Defence documented the April 2020 assessment of value for money in the SER for the evaluation of Austal's tender. The April 2020 assessment of value for money built upon a February 2020 value for money assessment that was conducted during the Risk Reduction Design Study process. Together, the two assessments addressed the requirement that Defence officials give consideration to the relevant financial and non-financial costs and benefits in assessing value for money.

February 2020 assessment of value for money (VFM)

2.58 Defence conducted an initial assessment of value for money with the Project Director Patrol Boats as the team lead and representatives from across CASG between 21 January and 12 February 2020.

2.59 The Source Evaluation Report states that the February 2020 value for money assessment:

... determined that the proposal contained sufficient merit to justify proceeding with initial procurement activities. The overall outcome of the assessment is that VFM is evident within the final Austal proposal and that the associated VFM issue notes were considered by the Delegate in directing to proceed with the CDP [Collaborative Development Process]. This consideration was made by the delegate, considering the relevant financial factors identified within the VFM report, together with any non-financial cost and benefit assessments undertaken by Navy.

2.60 The February 2020 value for money assessment was limited to an assessment of financial costs and benefits. The February 2020 Evolved Cape Class Unsolicited Proposal - Value for Money Assessment Summary Report for Delegate Endorsement, advised the delegate that:

52 Department of Finance, *Commonwealth Procurement Rules*, April 2019. CPR paragraph 4.5 provided that: 'Price is not the sole factor when assessing value for money. When conducting a procurement, an *official must* consider the relevant financial and non-financial costs and benefits of each *submission ...*'. CPR paragraph 4.6 set out that whole-of-life costs could include: the initial purchase price of the goods and services; maintenance and operating costs; transition out costs; licensing costs (when applicable); the cost of additional features procured after the initial procurement; consumable costs; and disposal costs. [emphasis in original]

Per Division 1, Section 4, achieving VFM is the core rule of the Commonwealth Procurement Rules (CPRs). The VFM assessment covered by this report relates to that part of the Austal proposal which involves procurement of the vessels, being the costs leading to a purchase price for the Commonwealth if it were the case that a traditional fixed price acquisition contracting arrangement were used. Should this activity progress as a lease, this purchase price would then be used as an input to leasing provisions and an overarching assessment of value compared with Armidale LOTE, which is not covered within this report.

2.61 The VFM assessment team was therefore considering whether or not, for the scope proposed by Austal (including consideration of risk), the components making up the price of the offer were VFM.

2.62 The value for money assessment considered the costs associated with the acquisition contract with Austal but did not include sustainment funding for the evolved Cape class.⁵³ The cost assessment considered the individual components making up the price, including attribution of profit and overhead margins, on a contract price and per boat price basis. Defence also conducted a detailed assessment of overheads and profit using the CASG Cost and Profit principles, and requested substantiating data.

2.63 Defence was, in principle, well placed to assess the quality of the goods and services being offered by Austal. Defence was leasing two Cape class patrol boats for Navy service and could also draw on the Australian Customs and Border Protection Service's (now the Australian Border Force within the Department of Home Affairs) experience in procuring Cape class patrol boats and contracting with Austal for their sustainment. Nonetheless, the only documented assessment undertaken of Austal's past performance in the February 2020 VFM assessment was the statement that:

Austal's relevant experience and performance history, limited to acquisition of the Guardian Class Pacific Patrol Boat (GCPB) and Capes 9 & 10, rather than any assessment of their performance in the sustainment of vessels, can also be considered a positive non-financial factor in any wider VFM assessment.⁵⁴

2.64 The VFM assessment highlighted a number of key considerations to be taken into account by the delegate. These included: learning curve efficiencies; the application of overhead to materials; and the proportion of Austal's Australian overheads being attributed to the evolved Cape class project.

April 2020 assessment of value for money

2.65 The TEB reported that Austal met the requirements for the subject procurement activity and represented value for money for the Commonwealth. The TEB considered that Austal's RFT response was 'an improved VFM position, in excess of that previously considered for the 'revised unsolicited proposal' of 4 February 2020, with 'significantly reduced risk and only an immaterial

53 The assessment also did not include items which have since been funded under reallocated SEA 1180–1 transition funding, or the reallocation of Navy Minors Capital Program funding to fund a portion of the acquisition costs for sea boats for the evolved Cape class. See paragraphs 1.19–1.21 and Table 1.1 for more detail on these funding allocations and related expenditure.

54 ANAO comment: Defence records indicate that Defence had previously expressed 'serious concerns about Austal's capability and performance' under sustainment and acquisition contracts with the department.

increase in the tendered contract price, as a result of a minor increase in scope.’ This assessment relied on the February 2020 VFM assessment of financial costs and benefits.

2.66 In its April 2020 assessment of value for money, the TEB considered a number of non-financial factors, including: Austal’s past performance of contractual obligations; the proposed corporate structure and proposed approved subcontractors; the financial and corporate viability of Austal; the extent to which the tendered solution for the Mission System and Support System would meet end user and operational capability needs and requirements set out in the draft statement of work; and the extent to which Austal could deliver the supplies necessary to meet the requirements of the draft statement of work.

Testing the market

2.67 As discussed in Box 1 above, the July 2019 DPPM stated that:

... if Defence officials act on [unsolicited] proposals without testing the market, then it may be unfair to other suppliers of similar goods or services, as well as being difficult to demonstrate value for money.

2.68 Defence did not test the market at any point in the procurement process.⁵⁵ Consistent with the direction of CNSAC of 4 October 2019, CASG proceeded to engage Austal for the RRDS activities without testing the market (as discussed in paragraphs 2.28–2.31). The RFT for the procurement of six evolved Cape class boats was also sole sourced to Austal.⁵⁶ Both procurements cited Commonwealth Procurement Rule 2.6 to enable sole sourcing.⁵⁷

Benchmarking costs

2.69 Defence’s April 2020 assessment of value for money relied on benchmarking undertaken for its February 2020 assessment, when Defence had benchmarked Austal’s costs with internally held information on Cape class related costs. Parallel to the procurement process, a Defence official and a contracted financial analyst conducted assessments of the whole of life costs of the Austal proposal compared to: the planned Armidale class LOTE, supplemented by extending the lease of Cape class patrol boats 9 and 10 in Navy service.

2.70 The ANAO’s review of the two cost assessments indicated that:

- Both cost assessments utilised cost build up information supplied by Austal between 21 January and 11 February 2020. Defence advised the ANAO in December 2021 that it compared this information with ‘known Armidale Class Patrol Boat and CCPB costs,

55 Defence advised the ANAO that it ‘already had established market reality because of experience with Defence CCPB and Defence ACPB performance and costs, and as such had significant expertise in VFM assessment and total cost of ownership. Defence had real time information on running costs for Capes 1 through 10. Defence also leveraged design enhancements being incorporated on the concurrent Trinidad Tobago Cape Class build at Austal in 2019. It is important to also note that no other ship builder in Australia makes a littoral patrol vessel of this class or standard.’

56 See paragraph 2.40 above.

57 As discussed in footnote 6, paragraph 2.6 of the April 2019 CPRs stated that: ‘These CPRs do not apply to the extent that an *official* applies measures determined by their *Accountable Authority* to be necessary for the maintenance or restoration of international peace and security, to protect human health, for the protection of essential security interests, or to protect national treasures of artistic, historic or archaeological value.’ [emphasis in original]

periodicities and events as experienced in Patrol Boat Systems Program Office and the CN09 program’.

- Both cost assessments assessed the whole of life costs of the Armidale class LOTE option compared to the Austal proposal option. The assessed whole of life costs included Armidale sustainment costs, lease and in-service sustainment costs for Cape class boats 9 and 10, and lease and in-service sustainment cost estimates for the evolved Cape class boats.
- Only one of the cost assessments accounted expressly for residual value on Cape class boats 9 and 10 and the evolved Cape class boats.

2.71 Estimated savings decreased with iterative refinement of the cost assessments, with the final versions of the two cost assessments estimating savings from implementing the Austal proposal over the Armidale class LOTE at \$50.253 million and \$12.306 million respectively, compared to the earliest estimates of approximately \$328.799 million and \$226.481 million respectively. The final estimates reflected a revised Austal option involving delayed withdrawal of the evolved Cape class boats and Armidale class boats, in order to maintain minimum Patrol Force availability of 12 hulls, as directed at the CNSAC meeting of 13 February 2020.

2.72 Defence informed the ANAO that its assessment of the Austal proposal against its capability requirements was also informed by its knowledge of the Cape class product based on its previous assessment of the Cape class in 2015 and its ongoing lease of two Cape class boats.⁵⁸

2.73 Key decision documents did not include a cost comparison between the whole of life costs of the transition plan based on the Armidale LOTE and the alternative option of implementing the Austal proposal in some form, or document consideration of the Australian Customs and Border Protection Service’s⁵⁹ acquisition of eight Cape class patrol boats for the Commonwealth.⁶⁰

2.74 In February 2020 the Defence Science and Technology Group (DSTG) assessed the availability of patrol vessels to be provided under Austal’s proposal against the original transition plan via LOTE of the Armidale class. DSTG reported that both the Austal proposal as at October 2019 and the Armidale LOTE plan would not meet Navy requirements of vessel availability, but that the Armidale LOTE plan offered better availability than the Austal proposal. Availability was not reassessed by DSTG as part of the tender process. The Austal proposal assessed by DSTG in its report was overtaken by the revised Austal proposal received by Defence on 4 February 2020.

58 In 2015 Defence planned a rolling program of hull remediation of the existing Armidale class fleet, during which a supplementation of Patrol Force capability was deemed to be required to undertake Operation Resolute. Defence considered two options for supplementing the Armidale class capability: Damen’s modified FCS 5009 and the Austal Cape class. This process included an assessment of written proposals and on board experience of each platform.

59 Now the Australian Border Force (ABF), a part of the Department of Home Affairs.

60 That acquisition and sustainment process was examined in Auditor-General Report No.13 2014–15 *Management of the Cape Class Patrol Boat Program* and Auditor-General Report No.21 2018–19 *Cape Class Patrol Boat — In Service Support Arrangements*. Defence advised the ANAO in October 2021 that ‘the ABF sustainment contract is quite different to the Defence extant CCPB In Service Support Contract including a significant difference in the Management Maintenance System employed and Standard Activities applied, hence the ABF contract was not considered.’

Were relevant probity requirements applied in the course of the procurement?

Defence did not assess potential probity risks on receipt of the unsolicited proposal from Austal in September 2019 or introduce additional arrangements to manage procurement probity risk until it commenced exclusive negotiations with Austal in February 2020. This was five months after receipt of the proposal.

It would have been prudent for Defence to consider its probity arrangements for its personnel earlier than it did. Defence records indicate that prior to receipt of the unsolicited proposal, Austal personnel provided Defence personnel with information and modelling relating to the idea of acquiring additional Cape class boats as an alternative to the Armidale class LOTE, to support Navy's transition to the Arafura class offshore patrol vessels (OPVs). While the ANAO did not identify direct evidence of joint development of the unsolicited proposal before it was formally received, and Defence advised that joint development did not occur, in such circumstances care needs to be taken to avoid the perception of joint development of a proposal which may result in procurement action, so as to avoid any perception that potential suppliers enjoy an unfair advantage. Non-discrimination is a key principle of the CPRs.

2.75 The July 2019 DPPM stated that:

Attention to probity is integral to ensuring the defensibility, transparency and success of Defence procurements. Defence's publication, *Defence and the Private Sector — An Ethical Relationship* set out a framework of standards of ethical behaviour for relationships between Defence and the private sector.⁶¹

2.76 The ANAO examined Defence's management of probity during its assessment of the unsolicited proposal and its sole source procurement process.

Defence's engagement with Austal prior to receipt of the proposal

2.77 As discussed in paragraph 1.7, the Deputy Secretary of Defence's Capability Acquisition and Sustainment Group (CASG) and the Chief of Navy received, on 5 and 6 September 2019 respectively, an unsolicited proposal from Austal for the lease of six new Cape class boats and to retire early the Navy's Armidale class boats rather than perform any LOTE work on them.

2.78 Defence records indicate that Defence routinely engages with Austal on a range of matters. Between April and September 2019, prior to receipt of Austal's unsolicited proposal, Defence records indicate that Austal personnel provided Defence personnel with information and modelling relating to the idea of acquiring additional Cape class boats as an alternative to the Armidale class LOTE, to support Navy's transition to the Arafura class vessels.

2.79 In October 2021 Defence informed the ANAO that it 'did not formally request Austal to develop a proposal though it may have been pitched to representatives at this time'.⁶² Defence further advised the ANAO that the information and modelling provided was:

61 ANAO comment: this publication was accessible on the Defence website in 2019. It has since been removed from the website.

62 See also footnote 10. Defence advised the ANAO in October 2021 that: 'Defence (CASG) and agents therein do engage with Austal on a range of issues ... but did not seek formal advice or solicit proposals for six additional Cape Class Patrol Boats prior to the 5 September 2019 unsolicited proposal.'

... part of an aggressive business development approach that continued throughout 2019 but was not considered at any stage until subsequent receipt of the unsolicited proposal of 5 September 2019, noting risks and costs for ACPB LOTE [Armidale class patrol boat life-of-type extension] at this latter date were better understood by Navy.

2.80 While the ANAO did not identify direct evidence of joint development of the unsolicited proposal before it was formally received by Defence in September 2019, and Defence has advised that joint development did not occur, in such circumstances care needs to be taken to avoid the perception of joint development of a proposal which may result in procurement action, so as to avoid any perception that potential suppliers enjoy an unfair advantage. In this respect, a key principle of the CPRs is non-discrimination, which is expressed as follows:

- 5.3 The Australian Government's procurement framework is non-discriminatory.
- 5.4 All potential suppliers to government must, subject to these CPRs, be treated equitably based on their commercial, legal, technical and financial abilities and not be discriminated against due to their size, degree of foreign affiliation or ownership, location, or the origin of their goods and services.⁶³

Defence's management of probity following receipt of the September 2019 proposal

2.81 When Defence commenced its assessment of the Austal proposal in September 2019, it did not establish specific arrangements for Defence officials to manage potential probity risks arising from direct engagement with the company or remind those involved of their probity obligations. Furthermore, Defence did not assess the potential probity risks at that time.

2.82 Defence did not implement specific formal probity arrangements for the evolved Cape class patrol boat procurement until February 2020, when it commenced the Collaborative Development Process. Defence advised the ANAO in October 2021 that:

... the Defence Integrity Framework including Defence Integrity Manual applied at all times including prior to introducing probity arrangements in February 2020. This includes requirements for officers in relation to declaring conflicts of interest, gifts, hospitality and employment offers.

... Persons engaged by Defence as advisors...are subject to similar obligations under their respective terms of retainer or contracts (including duties to disclose conflicts of interest and maintain confidentiality).

... Defence considers there were suitable probity arrangements in place prior to February 2020 to manage probity risks as there were legal and contractual probity obligations on both APS staff and contractors/advisers.

2.83 It would have been prudent for Defence to assess probity risk and remind those involved of their probity obligations before February 2020, as Defence documentation indicates that Austal received early signals, whether correct or not, from Defence personnel that it would be engaged to deliver up to six new Cape class patrol boats. Specifically:

- On 22 October 2019, at a meeting with Defence on the scope of the RRDS, Austal had taken an action item to commence drafting a contract for the Cape class acquisition, based

63 Australian Government, Department of Finance, *Commonwealth Procurement Rules*, paragraphs 5.3 and 5.4.

on the existing Pacific patrol boat contract.⁶⁴ This was some four months prior to the Collaborative Development Process which commenced on 21 February 2020 for the purpose of developing the contract (discussed at paragraph 2.32 onwards).

- The scope of the RRDS, as described in the endorsement to proceed and communicated to Austal in the request for quote for the work on 15 November 2019, included the following statements of intention to proceed with the Austal proposal:
 - 1.2 Specialist Ships [a branch within CASG] proposes to lease up to six (6) new CCPBs based on an existing design to supplement the Armidale Class Patrol Boats prior to the delivery of the Offshore Patrol Vessel (OPV).
 - 1.3 Specialist Ships is proposing the lease of the platforms may comprise the following steps:
 - a. a Risk Reduction Design Study (RRDS) (this contract);
 - b. potentially, a Build and Lease Request for Tender (RFT) (to be developed after the commencement of the RRDS); and
 - c. potentially, an Offer Definition Improvement Activity (ODIA) following the evaluation of the tender.
 - 1.4 The Commonwealth's current intention is to build and lease the CCPBs in Australia with the commencement [of] construction [in] mid 2020.

2.84 These statements of intention to proceed with the Austal proposal could have been more clearly qualified. The available documentation indicates that Austal was not clearly advised in the request for quote that its engagement on the RRDS process did not constitute acceptance of its proposal at that time or in the future. A separate RRDS Special Conditions document, which Defence advised the ANAO in December 2021 was part of the RRDS documentation provided to Austal as part of the Survey and Quote request, included caveats, including that:

... the Commonwealth may elect not to proceed, and makes no commitment to proceed, to any future stage of the procurement process for the Project.

2.85 Defence records also indicate that:

- On 1 November 2019 at 9.36AM, a Defence contractor forwarded a chain of ten unclassified emails outlining internal Defence deliberations on the draft statement of work for the RRDS to Austal. At 9.40AM on the same day, Defence's draft statement of work was emailed to Austal.⁶⁵
- On 6 April 2020, the day of government consideration of the Austal proposal, Austal commenced cutting steel (bracket for a fuel tank). A Defence contractor engaged by CASG

64 With regard to the work conducted alongside Austal from September 2019, Defence advised the ANAO in October 2021 that 'the 22 October 2019 work was part of a longer process of feasibility studies and any commercial arrangements were completely and wholly within that phase of engagement, and that subsequent statements of 15 November 2019 were included to scope this work moving forward.'

65 Defence advised the ANAO in November 2021 that the draft statement of work was provided to Austal to 'better define, focus and improve the understanding of the requirements of the RRDS and as per normal business practices in a limited tender release, the draft sought any input from Austal to minimise timeframes for consideration of this phase of the feasibility study.' In relation to the 10 emails, in December 2021, Defence further advised the ANAO that: 'As advised by DEPSEC CASG in his letter of acknowledgement to Mr David Singleton CEO Austal Australia ... "I have directed my team to work collaboratively with you to explore in detail the feasibility of the Cape Class Lease Proposal".'

(from Jacobs Group (Australia) Pty Ltd, an engineering firm) was present as a Commonwealth representative to monitor production quality. Defence informed the ANAO that it had advised Austal that the early commencement of work was at its own risk.

2.86 There would be merit in Defence developing specific requirements for the management of probity when considering and assessing unsolicited proposals received from industry, to support the defensibility and transparency of any procurement decisions resulting from such proposals.

Recommendation no. 1

2.87 The Department of Defence develop and implement specific requirements for the management of probity when engaging with industry on unsolicited proposals including by identifying, assessing and managing probity risk at an early stage, when considering and assessing the feasibility of unsolicited proposals.

Department of Defence response: *Agreed.*

2.88 *Defence agrees to the recommendation.*

Defence's management of probity during the Collaborative Development Process (CDP)

2.89 The CDP Engagement Directive of February 2020 (discussed in paragraph 2.33) outlined probity arrangements for the CDP with reference to relevant sections of the DPPM. The arrangements established included detailed procedures in relation to offers of employment, gifts and hospitality offers, conflicts of interest more broadly (declaration and management), security and confidentiality, and communications with Austal.⁶⁶

2.90 The directive made provision for the Chief Contracting Officer, Materiel Procurement Branch, to act in the role of probity manager for the CDP, as well as for external lawyers (Clayton Utz) to provide probity advice on request. The directive also required CDP team members to be conversant with and comply with relevant Defence guidance, namely chapters of the Defence Procurement Policy Manual pertaining to ethics and fair dealing and negotiation and contract formation.

2.91 The directive expressly limited the authority of the CDP team, noting that it did not have authority to: deviate from normal Commonwealth policies; agree to any significant changes to the draft contract outside of guidance provided in the directive without first obtaining agreement from the delegate; or sign any document or give verbal undertakings on behalf of the Commonwealth committing it to a position until all specialist reports had been received and a section 23 commitment approval delegation had been exercised.

2.92 While the CDP Engagement Directive made provision for an RFT process, the Tender Evaluation Plan (TEP) included additional probity arrangements for this process. The TEP included a requirement for Tender Evaluation Organisation members to complete a deed of confidentiality

⁶⁶ The CDP documentation advised the CDP team (in February 2020) that it must not give Austal the impression that they are certain to get a contract because such an impression undermines the Commonwealth's position and may give rise to a claim of damages based on estoppel or misrepresentation if Austal ultimately does not get the contract.

and/or a conflict of interest declaration. Additionally, the TEP required the TEB chair to brief all TEO members on the contents of the TEP, including requirements pertaining to probity, ethics and fair dealing; conflicts of interest; and security, privacy and confidentiality.

2.93 All members of the TEB completed conflict of interest declarations prior to the commencement of the tender evaluation. Four of the nine advisors listed in the TEP did not complete conflict of interest declarations.⁶⁷ Two additional individuals engaged in the tender evaluation process completed declarations.⁶⁸ No conflicts of interest were declared in any of the declarations.

Did Defence effectively advise government?

Defence's advice to government was largely effective. The advice was timely, but it did not always fully or clearly present the risks, costs and impacts associated with the transition plan for the Navy's patrol boat force, or the rationale supporting the evolved Cape class procurement.

2.94 Government requires clear, accurate, timely and complete information on which to make decisions. The ANAO reviewed 14 submissions from Defence to its Ministers and the government relating to the transition from the Armidale class to the Arafura class, including eight relating to the government's decision to procure the six evolved Cape class boats. The submissions were provided between November 2017 and April 2020. The ANAO examined whether Defence's advice was informed by an appropriate range of evidence and was timely and complete.

2.95 During the course of Defence's activities to assess the unsolicited proposal, it provided a range of advices to its Ministers, including a draft submission for the Minister for Defence to consider submitting to the government seeking approval for the acquisition of the evolved Cape class patrol boats.

2.96 Defence provided timely advice to its Ministers and the government to assist in the consideration of key event and decision points.

2.97 Defence's advice to its Ministers in relation to the Austal proposal reported on studies commissioned by Defence⁶⁹, correspondence from Austal, internal planning, and analysis including

67 Noting that the TEP did not require advisors to complete declarations, two of these advisors were Defence officials, providing legal and probity, procurement and contracting advice. The two remaining advisors were contractors providing financial and technical and engineering advice. One of the legal and probity advisors who did not provide a declaration was an SES member of the Defence Senior Leadership Group. Pursuant to Defence Instruction Administrative General 5, members of the Senior Leadership Group are required to provide annual declarations of interest and maintain them during the year, so that no project specific declaration was necessary. Although not required by the TEP, five of the nine advisors did complete conflict of interest declarations.

68 Defence advised the ANAO that one of these individuals was an additional advisor contracted for validation and verification under the SEA 3036 program engaged for targeted specific advice, while the other was an employee of the law firm assisting with preparing the contract. Defence further advised that these individuals were not involved in evaluating Austal's tender response.

69 Defence's advice to its Ministers reported the results of a LOTE study finalised in 2016, which used a representative vessel to assess the condition of the Armidale class boats, assess relevant risks and estimate the cost of potential LOTE work. The advice also reported on the results of the RRDS Summary Report that Austal provided to Defence in March 2020, at the conclusion of the RRDS. Defence's advice to its Ministers did not make reference to AMT's closing report on the RRDS dated 9 April 2020 (discussed at paragraph 2.30) or the February 2020 DSTG report (discussed at paragraph 2.74).

its assessments of value for money. Defence's advice to its Ministers largely aligned with the evidence available to Defence at the time.

2.98 Defence's advice to its Ministers partially considered relevant costs, benefits and risks, including the expected cost of the evolved Cape class acquisition and other transition plan activities, potential adverse effects on industry partners of early withdrawal of the Armidale class, and the risk of low patrol force availability during the transition period. The advice also largely considered the impacts of these matters, including potential cost reductions and improved reliability of the patrol force and potential Austal workforce redundancies if the proposal was not progressed. Examples of where there was no or minimal information presented on costs, risks and impacts included:

- Defence's December 2019 background brief for the ministerial meeting with the CEO of Austal, which discussed the Austal proposal but did not raise cost or risk, or absence of risk, associated with the proposal.
- Defence's April 2020 recommendation to purchase rather than lease the Cape class boats, which did not identify risk, or absence of risk, associated with the finance approach.

2.99 The key 1 April 2020 advice to government, drafted for its Minister by Defence:

- set out the following components of Defence's value for money assessment—consideration of cost drivers, the Defence Cost and Profit principles, and reference data from other Defence maritime programs — and advised that the assessment found the proposal represented value for money. The advice also stated that the value for Money Assessment Report was available to government upon request;
- advised that the evolved Cape class acquisition would reduce cost, materiel and operational risk to Defence compared to the LOTE of Armidale class boats;
- indicated that acquisition of the Cape class boats would allow Defence to support Australian industry through the procurement, including through facilitating the retention of around 400 Austal employees who would otherwise be made redundant. The advice also noted that cancelling the planned Armidale class LOTE would reduce the planned expenditure of about \$90 million on Australian industry for maintenance of the Armidale class; and
- outlined whole of life costings for three scenarios. These were: undertaking a transition plan to the Arafura class that included a LOTE for six Armidale class boats; purchasing six evolved Cape class boats; and leasing six evolved Cape class boats. These options were costed at \$1.157 billion (LOTE), \$1.126 billion (purchase) and \$1.194 billion (lease) respectively, with Defence estimating cost savings for the purchase option for the transition to the Arafura class being approximately \$31 million.

2.100 The advice recommended that the government approve the construction of six Cape class boats at a not-to-exceed cost of \$353.3 million. Defence advised the ANAO that this figure was based on an Austal estimate of \$322.2 million (GST exclusive) for the price of the boats and \$7.8 million for capitalised interest if the boats were leased. In contrast, the cost model supplied by Austal in February 2020, described as the 'Final Offer from Austal', had proposed a contract value of \$324.1 million (GST exclusive), which remained unchanged and formed the GST exclusive contract price in the contract signed on 30 April 2020.

2.101 The government approved the acquisition of six evolved Cape class patrol boats on 6 April 2020. The government also agreed that the Minister for Defence and Minister for Finance would determine the appropriate funding method — either to lease, purchase outright, or a combination of both by exchange of letters. On 30 April 2020 the Minister for Finance wrote to the Minister for Defence agreeing to the purchase of six evolved Cape class boats from Austal at a total cost of up to \$345.5 million. This amount was less than agreed by government due to the decision to purchase outright, as the 6 April 2020 government approval included \$7.8 million in capitalised interest from leasing.

2.102 On 30 April 2020, Defence and Austal signed a contract for the acquisition and build of six evolved Cape class patrol boats. The contract value was \$356,795,568 (GST inclusive).

3. Contracting and delivery

Areas examined

This chapter examines the contracting and delivery phases of the evolved Cape class patrol boat acquisition.

Conclusion

Defence has implemented largely appropriate contracting, governance and reporting arrangements to support the acquisition. Two mandated governance documents had not been approved as at 1 December 2021, and no independent assurance reviews have been conducted to date. Therefore, Defence and its senior leaders have not had the benefit of the full suite of inputs which help provide assurance that capability requirements are being successfully delivered. Defence has undertaken an appropriate range of activities to date to manage project milestones. However, anticipated delivery delays of 26 to 35 weeks, resulting from the contractor's need to undertake rectification work following the use of defective aluminium, and the production workforce inefficiencies it has reported, have required Defence to plan for the extension of service of Armidale class patrol boats and a reduced in-service period for the evolved Cape class. As of July 2021 net additional costs arising from projected delivery delays for the delivery of the evolved Cape class and the Offshore Patrol Vessels are estimated by Defence at \$43.9 million.

Areas for improvement

The ANAO identified one area for improvement relating to timely compliance with internal requirements for the preparation of a Product Delivery Agreement (previously known as a Materiel Acquisition Agreement) and Integrated Project Management Plan.

3.1 Sound project governance and contract management arrangements support the effective management of procurement risks and the timely delivery of capability on budget and against requirements.⁷⁰ The delivery of contracted capability on time and on budget also supports the actual achievement of value for money in procurement.

3.2 This chapter considers Defence's contracting and delivery arrangements for the acquisition of evolved Cape class patrol boats, focusing on whether Defence:

- established fit-for-purpose contracting arrangements for the acquisition;
- established effective project and contract governance arrangements; and
- has managed project milestones and the delivery of capability requirements effectively to date.

70 With regards to its broader ship building activities, Defence has previously observed that key risks in naval ship building relate to the delivery of expected capability, program cost, ability to meet program schedules, and management of the industrial base. See: Auditor-General Report No.39 2017–18 *Naval Construction Programs—Mobilisation*, p. 44.

Did Defence establish fit-for-purpose contracting arrangements for the acquisition?

Defence has established fit-for-purpose contracting arrangements for the acquisition. Defence's contract with Austal includes 20 milestones, with clear entry and exit criteria and due dates. Contract payments are tied to the achievement of milestones. Payment amounts are appropriately distributed to incentivise satisfactory contractor performance, with amounts held over until achievement of acceptance milestones. Performance expectations are clearly set out in the contracted statement of work, with additional detail about consequences for poor performance included in the conditions of contract. Provisions for corrective action are included in the contract, as are provisions for the payment of liquidated damages.

3.3 Contracting arrangements establish the formal framework for managing the delivery of capability and the relationship between Defence and its contractor. To assess whether Defence established fit-for-purpose contracting arrangements for the acquisition of the six evolved Cape class patrol boats, the ANAO examined:

- the contract, with a particular focus on the arrangements for managing performance, security, scope, schedule and payments; and
- whether the contract has been varied and by how much. The nature and number of contract variations can be an indicator of the fitness-for-purpose of the original contract.

Contracted arrangements

3.4 The 20 key negotiation outcomes agreed during the Collaborative Development Process (CDP) (discussed in paragraphs 2.32–2.38) were documented in the contract.

3.5 The contract also incorporates mechanisms to manage performance, including:

- the requirements set out in the contracted Statement of Work (the SoW, attached to the contract, discussed further at paragraph 3.9–3.10);
- milestone entry and exit criteria and milestone due dates (discussed at paragraphs 3.11–3.15 and 3.73–3.77);
- a provision that 26 per cent of the relevant boat's milestone payments are tied to the acceptance milestones, with an additional final acceptance milestone amounting to five per cent of the total contract value reserved until final acceptance;
- provisions for Defence to take corrective action, including the application of liquidated damages and/or termination of the contract; and
- entry criteria for acceptance milestones that are linked to the achievement of the planned Australian Industry Capability (AIC) spend.

3.6 Austal's liability was capped in the contract for certain categories of liability, consistent with the Australian Standard for Defence Contracting (ASDEFCON) contracting templates and based on the findings of a liability risk assessment.⁷¹

3.7 Under the contract Austal is required to obtain and maintain all elements of DISP membership at the 'FOR OFFICIAL USE ONLY' level. Austal applied for a new DISP membership on

⁷¹ Caps on liability were calculated by Defence.

24 March 2021. Austal obtained DISP membership in alignment with the requirements of the acquisition contract on 31 October 2021.⁷²

3.8 Defence advised the ANAO in December 2021 that it had released classified information to Austal during the course of the project:

This is done on the basis of para 9-10 of Annex D to Control 10.1 of the Defence Security Principles Framework, which permits release of OFFICIAL: SENSITIVE information to non-DISP accredited contractors that have both an existing contract with Defence and a need-to know the information, subject to a risk assessment. The risk of providing OFFICIAL: SENSITIVE information to Austal is assessed as low due to the clearly established need to know and long history of engagement between Austal and the Commonwealth at this level of security classification.

Contracted statement of work

3.9 The scope of work for which Austal has contracted is set out in the SoW. The SoW includes a description of the requirement, which is made up of various specifications (including, for example, functional and performance specifications and systems specifications).

3.10 Under the description of requirement, Austal is required to develop and deliver for Defence's approval the Evolved Cape Class Patrol Boat (ECCPB) System Specification and a Support System Specification (SSS) based on the Cape class 9/10 System Specification, as at 1 November 2019 and as modified by Risk Reduction Design Study (RRDS) changes.

Delivery milestones

3.11 The contract sets out 20 milestones with clear entry and exit criteria, due dates, and payment amounts. For each boat there is a milestone A, milestone B and an acceptance milestone (set out in Table 3.1 below). The remaining two milestones relate to: advance equipment orders and final acceptance of all six evolved Cape class boats.

Table 3.1: Milestones under the acquisition contract

Milestone number	Milestone description ^a	Milestone type ^b	Milestone date
1	Boat 1 Milestone A	–	30/04/2020
2	Advanced Equipment Orders	–	1/06/2020
3	Boat 2 Milestone A	–	27/07/2020
4	Boat 3 Milestone A	–	23/11/2020
5	Boat 4 Milestone A	–	15/03/2021
6	Boat 1 Milestone B	–	9/04/2021
7	Boat 2 Milestone B	–	21/06/2021
8	Boat 5 Milestone A	–	5/07/2021
9	Acceptance Boat 1	LD	17/09/2021

⁷² Membership had previously been held since 2001 and lapsed due to Defence ceasing to recognise DISP memberships established prior to April 2019. Auditor-General Report No.4 2021–22 *Defence's Contract Administration — Defence Industry Security Program* reported that the average processing time for DISP membership applications from April 2019 to January 2021 was 6.6 months.

Milestone number	Milestone description ^a	Milestone type ^b	Milestone date
10	Boat 3 Milestone B	–	18/10/2021
11	Boat 6 Milestone A	–	25/10/2021
12	Acceptance Boat 2	LD	10/12/2021
13	Boat 4 Milestone B	–	7/02/2022
14	Acceptance Boat 3	LD	8/04/2022
15	Boat 5 Milestone B	–	30/05/2022
16	Acceptance Boat 4	LD	12/08/2022
17	Boat 6 Milestone B	–	19/09/2022
18	Acceptance Boat 5	LD	25/11/2022
19	Acceptance Boat 6	LD	24/03/2023
20	Final Acceptance	–	24/03/2024
Total value			\$356,795,568

Note a: Milestone A for each boat pertains to the commencement of production, specifically the cutting of structural material. Milestone B for each boat pertains to the launch of the relevant boat and provision of a launch certificate signed by Defence. The acceptance milestones concern Defence's formal acceptance of the relevant boat from Austal and the transfer of ownership to the Commonwealth. Defence advised the ANAO in December 2021 that 'Milestones for each boat include consideration of the production status of the vessel, the development of the support system, and other key requirements of the Contract at the relevant stage of the program.'

Note b: LD indicates that a milestone is a liquidated damages milestone, with late delivery giving rise to liquidated damages under the contract.

Source: Defence records.

3.12 The entry and exit criteria for each milestone set out the documentation to be prepared or activities to be performed. Each milestone requires a Commonwealth representative to certify its acceptance and/or approval of the exit criteria components.⁷³

3.13 Defence records indicate that the advance equipment order milestone was included to support Austal in making early payments to industry, to provide increased confidence to the supply chain in the COVID-19 environment. Defence undertook assurance activities in relation to ensuring that the minimum value of \$11.39 million in advance equipment orders had been made as required by the milestone at least five working days prior to the planned milestone date. This included obtaining evidence that relevant orders had been made in the required quantities and that associated payments had been made, which included linking payment transactions to subcontracts and letters of intent provided by Austal.

3.14 Milestone 3 deliverables (Boat 2, Milestone A) included finalisation of the Australian Industry Capability (AIC) plan. At signature, the contract did not include an agreed plan, but did set

⁷³ Examples of relevant certificates include production commencement certificates, launch certificates and acceptance certificates.

AIC expenditure at \$219.9 million (68 per cent of total expected expenditure under the contract).⁷⁴ The agreed conditions of contract established that Austal shall achieve the agreed AIC expenditure and submit an AIC plan for approval. The AIC plan was:

- submitted by Austal on 25 June 2020;
- re-submitted to address identified deficiencies⁷⁵;
- approved by Defence on 20 November 2020; and
- incorporated into the contract on 10 April 2021 following Austal's submission of a contract change proposal on 26 February 2021.

3.15 The approved AIC plan included a revised (higher) AIC expenditure of \$222.6 million (69 per cent of total expected expenditure under the contract). The AIC plan also noted that it would: support an average of 405 full time equivalent jobs within Austal; support 1,170 full time equivalent jobs within its supply chain; and provide more than 300 different Australian companies with purchase orders.⁷⁶

Contract Master Schedule

3.16 The Contract Master Schedule establishes the performance measurement baseline and is to be used as the primary schedule for managing the contract⁷⁷, with information to be provided on the contractor's planned sequence of activities, milestones and decision points necessary to meet the objectives of the contract.

3.17 The contracted SoW requires Austal to develop, deliver and update a Contract Master Schedule with the Contract Status Reports. As at December 2021, this was on a monthly basis.⁷⁸

Contract variations

3.18 As at 1 December 2021 there were six approved contract change proposals (CCPs).⁷⁹ Of these there were no price-impacting CCPs. The approved CCPs concerned matters including: reallocation of AIC plan approval from milestone 3 to milestone 4⁸⁰ and incorporation of the approved AIC plan into the contract.

74 As noted in Chapter 2, the Commonwealth relied on Austal's representation that it will achieve the AIC expenditure in determining that the contract is value for money. Defence advised the ANAO on 1 October 2021 that the AIC plan was not included in the contract at signature due to the time required to incorporate changes in the AIC plan requirements from the Guardian class patrol boat contract to the evolved Cape class contract and ensure alignment with the relevant data item description in the contract.

75 Deficiencies identified in earlier versions of the AIC plan included: generalisations; unclear methodology for job creation; absence of approach to indigenous enterprises and indigenous employment; further detail required on issues such as intellectual property rights; and speculative comments about future Defence procurement.

76 Paragraph 2.2.2.1 of the approved AIC plan states that 'Over the course of the Program there will be more than 1,570 FTE local jobs supported in Australia ... at Austal and within the Austal supply chain.'

77 The Contract Master Schedule is intended to assist the management of contracted deliverables including through providing assurance that the contractor can meet its contractual obligations and assisting with monitoring the progress of the contractor.

78 Defence's review comments on the Contract Status Reports noted on several occasions that the reporting periods for the Contract Status Report and Contract Master Schedules did not always align as required.

79 Contract change proposals are to be reviewed and approved by a Contract Change Control Group.

80 AIC plan approval was reallocated from milestone 3 to milestone 4 to allow additional time for approval while not delaying payment of the milestone.

3.19 As at 2 December 2021, there was one variation in the AusTender records for the contract, with a value of \$748,218 (amounting to approximately 0.21 per cent of the original published contract value). This variation corrected a financial reporting error in the purchase order, related to escalation values. This variation does not correspond to any contract change proposal and did not require additional section 23 commitment approval as it was within the original section 23 commitment approval signed by the delegate on 29 April 2020. As noted in paragraph 3.18 there have been no price impacting contract change proposals to 1 December 2021.

3.20 As at 22 October 2021, 93 engineering change proposals were approved. Seventy were 'minor' or 'administrative' and 23 were 'major'.⁸¹ Seventeen of the 93 approved engineering change proposals pertained to the delivery of the 17 RRDS Impact Assessment items. Defence records show that these 17 items have been incorporated into the evolved Cape class System Specification through engineering change proposals.

Has Defence established fit-for-purpose governance arrangements for the acquisition?

Defence has established largely fit-for-purpose governance arrangements for its acquisition of six evolved Cape class patrol boats. The governance, oversight and coordination arrangements for the project include a combination of project-specific governance and oversight groups, as well as higher-level oversight and coordination arrangements for Defence's naval shipbuilding activity as a whole. The management of this acquisition is through CASG's sustainment arm. Defence has recognised the risk and complexity of these non-standard administrative arrangements, with the anticipated benefits expected to outweigh the risk.

Two mandated governance documents — the Product Delivery Agreement (Materiel Acquisition Agreement) and Integrated Project Management Plan — had not been approved as at 1 December 2021, and no independent assurance reviews have been conducted to date. As a consequence, Defence and its senior leaders have not had the benefit of the full suite of inputs which contribute to providing assurance that capability requirements are being successfully delivered by an acquisition project.

81 Major or 'Class I' changes are 'changes that change the Requirement Baseline, Functional Baseline, have a cost or schedule impact, or are High Risk and above'. Minor changes or 'Class II' changes are 'changes which are neither Class I or Class III'. Administrative or 'Class III' are 'changes of an administrative nature.'

Administrative, governance and coordination arrangements

Administrative arrangements

3.21 The Specialist Ships Branch (within the Maritime Systems Division of Defence's Capability Acquisition and Sustainment Group, CASG) is responsible for management of the SEA 1445–1 project.⁸² The project is managed day-to-day by the SEA 1445-1 project team.⁸³

3.22 The management of this acquisition is through CASG's sustainment arm. This administrative arrangement differs from other acquisition projects for Navy vessels, which are managed by CASG's Ships Division.⁸⁴ In a brief to the First Assistant Secretary, Ships, regarding these administrative arrangements, it was stated that:

Management of the program is being executed as a collaborative approach between Ships Division and Maritime Systems Division. This adds complexity to funding, resourcing, and responsibility determination and reporting arrangements, however it is envisaged that these complexities will be outweighed by the benefits that come from an integrated approach to acquisition and sustainment... [enabling] ... a progressive and highly informed integrated team to develop executable end-to-end arrangements and address the many unknowns associated with post-delivery support arrangements, which are yet to be scoped.

3.23 Defence has not mapped these non-standard administrative arrangements. CASG's project management policy notes that the 'governance strategy is to be documented in the Project Execution Strategy (PES) and its implementation is detailed in the IPMP [Integrated Project Management Plan]'. As at December 2021, Defence had not finalised these project governance documents. Defence advised the ANAO in October 2021 that the IPMP had been drafted but not yet endorsed.

Governance, oversight and coordination arrangements

3.24 Table 3.2 below outlines the relevant governance, oversight and coordination arrangements for the project, which include a combination of project-specific governance and oversight groups as well as higher-level oversight and coordination arrangements for Defence's naval shipbuilding activity as a whole.⁸⁵

82 The Assistant Secretary (SES Band 1/1 Star) Specialist Ships Branch also manages the sustainment of the Armidale class patrol boats and the two leased Cape class boats through the Patrol Boat Systems Program Office and one other acquisition project.

83 The project team is led by the Patrol Boat Program Director, who sits within the Specialist Ships Acquisition Branch and also has responsibility for the SEA-3036 Phase 1 — Pacific Patrol Boat Replacement (Guardian Class Patrol Boats), for which Austal is also the build contractor. In a brief to the First Assistant Secretary, Ships, regarding these governance arrangements, it was considered that this approach enabled a common approach to Defence's program level acquisition dealings with Austal.

84 Other acquisition projects include, for example: SEA 5000 Phase 1 — Hunter Class Frigates; SEA 1180 Phase 1 — Offshore Patrol Vessels; SEA 3036 Phase 1 — Pacific Patrol Boat Replacement.

85 Oversight and governance arrangements for naval shipbuilding activity have been established within Defence to provide governance, policy and coordination for the National Naval Shipbuilding Enterprise. This includes governance committees such as the Naval Shipbuilding Expert Advisory Panel and the Commonwealth, State and Territories Consultative Group on Naval Shipbuilding.

Table 3.2: ANAO mapping of governance, oversight and coordination arrangements for the evolved Cape class patrol boat acquisition

Governance and/or oversight body	ANAO comment
<p>Project Working Group</p> <p>Established following contract signature, with meetings ‘envisaged to be an interface between key stakeholders during the entire execution of the acquisition contract and into as much of the in-service phase as makes sense’.</p> <p>The Project Working Group includes representatives from the project, Navy (including a Director-General Littoral representative and Training Force) and Patrol Boat Systems Program Office.</p>	<p>Between June 2020 and late April 2021, the Project Working Group met on 17 occasions (approximately every two weeks).</p> <p>The minutes of these meetings indicate that it regularly considered updates from the representatives on the project and the transition, as well as having discussions on key project issues and risks.</p> <p>Defence informed the ANAO that the Project Working Group decides collectively what issues are escalated to the Integrated Project Team for review.</p>
<p>Transition Working Group</p> <p>The Transition Working Group was established under the Project Working Group in March 2021. It is responsible for managing the activities associated with the transition of the capability into service.^a</p>	<p>A transition matrix guides the meeting agendas for the Transition Working Group, with progress against each task reported by the respective owners.</p>
<p>Integrated Project Team — post-contract signature^a</p> <p>Responsible for overseeing delivery of the ECCPB product, including all Fundamental Inputs to Capability.^b</p> <p>Chaired by the Patrol Boat Program Director, with members from CASG and Navy (Director-General Littoral representative and Navy Engineering).^c</p>	<p>Between October 2020 and October 2021, the Integrated Project Team met eight times to discuss project governance.^c</p> <p>The minutes of six meetings^d indicate that it routinely considered the following matters:</p> <ul style="list-style-type: none"> the production schedule, achievement of key milestones and emerging issues; updates on the Fundamental Inputs to Capability, including work undertaken and emerging risks; and acceptance and transition of the patrol boats into service.
<p>One-Star Program Steering Group</p> <p>The SEA 1445-1 project utilises the SEA 1180 One-Star Program Steering Group.^e As of August 2020, the Terms of Reference for the group had not been updated to reflect responsibility for oversight of the SEA 1445-1 project.</p> <p>The Program Steering Group is co-chaired by the Director-General Littoral and Assistant Secretary Ship Acquisition—Specialist Ships, and receives input from its permanent membership, comprising a number of other Directors-General, the Project Director, and Assistant Secretary Specialist Ships.</p>	<p>The One Star Program Steering Group met six times since September 2019, with the Austal proposal and acquisition discussed in each instance. At the May 2020 meeting, the first following contract signature, it was agreed the project would be included in the Group’s meetings going forward. The minutes from these six meetings indicate that the following matters were routinely considered by the group with regard to SEA 1445-1:</p> <ul style="list-style-type: none"> the production schedule, achievement of key milestones and emerging issues; fundamental inputs to capability; and managing Navy’s capability during the transition between the Armidale and Arafura class patrol vessels.

Governance and/or oversight body	ANAO comment
<p>Maritime Mine Warfare, Patrol and Geospatial Program Two Star Program Governance Board</p> <p>The draft terms of reference set out that the board will be convened as necessary to manage the prioritisation of resources, realisation of benefits and efficiencies in relation to the Maritime Mine Warfare, Patrol and Geospatial Program.</p> <p>The board is chaired by the program sponsor, Head Navy Capability, and receives input from its permanent membership, comprising Deputy Chief of Navy and a number of other Two Star/Band Two level officers including Fleet Commander, Head of Maritime Systems (CASG), First Assistant Secretary Ships (CASG), and Director General Littoral.</p>	<p>As at 1 October 2021, the board had met once (in September 2021).^f</p>
<p>Naval Shipbuilding Coordination Group^g</p> <p>Meets fortnightly to discuss current issues and forecast progress in fulfilling the aims of the Naval Shipbuilding Plan and to circulate the planned approaches to government ahead of consideration by senior committees.</p> <p>Membership includes Three Star/Band Three Level officers and is attended by the Chief and Vice-Chief of the Defence Force, Associate Secretary and the Defence Secretary (Chair), and is also attended by Senior Executive Officers of the Department of the Prime Minister and Cabinet and the Department of Finance.</p>	<p>Project advice/information on SEA 1445-1 was provided by the Head Maritime Systems (Band 2/2 Star or their representative) at seven of the eight meetings held between December 2020 and June 2021.^h</p> <p>The meeting minutes noted that updates were provided on current risks and challenges, namely the impacts of the use of defective aluminium and production workforce shortfalls.</p>

Note a: There have been two iterations of the Integrated Project Team post-contract signature. Between June 2020 and October 2020, Defence advised the ANAO that the Integrated Project Team consisted of what is now the Project Working Group. Defence informed the ANAO in July 2021 that the Integrated Project Team evolved to include representatives for the Fundamental Inputs to Capability, and that working level project aspects would be managed by a sub-ordinate working group.

Note b: The Terms of Reference for the Integrated Project Team were endorsed in late July 2021.

Note c: Meeting minutes were not available for the two most recent Integrated Project Team meetings.

Note d: Meetings were held approximately every six to eight weeks, consistent with the Terms of Reference.

Note e: The program governance and arrangements for SEA 1180, including the One Star Program Steering Group are also discussed in Auditor-General Report No.12 2020–21 *Defence's Procurement of Offshore Patrol Vessels — SEA 1180 Phase 1*, paragraphs 3.26 to 3.28.

Note f: Meeting minutes were not available for this meeting.

Note g: The Naval Shipbuilding Coordination Group was established in 2016. As of August 2021, there were no signed Terms of Reference for the Group.

Note h: The group met regularly, approximately every two to four weeks.

Source: ANAO review of Defence documentation.

Project assurance arrangements

Arrangements to provide assurance on project delivery

3.25 The Defence Independent Assurance Review (IAR) process provides the Defence Senior Executive with assurance that projects and products will deliver approved objectives and are prepared to progress to the next stage of activity. These management-initiated reviews consider a

project's status while sufficient time remains for corrective action to be implemented. IARs are intended to commence at project initiation and are usually conducted on an annual basis through to FOC. They are an important input to key acquisition and sustainment decision points or milestones as defined in the Capability Life Cycle.⁸⁶

3.26 Defence's policy for IARs notes that:

All P3 [programs, projects or products] have a unique execution strategy, budget, schedule and set of risks and issues. Consequently, decision points listed at Annex B [key acquisition milestones] may not be applicable to every project. However, within the constraints of specific decision Gates and the capacity of the IAR Directorate, the Reviews should be scheduled based on the risks associated with the relevant decision point. In the case of Acquisition Category (ACAT) I and II projects, IARs should ideally be conducted on an annual basis.

3.27 Defence has classified the evolved Cape class patrol boat acquisition as an Acquisition Category (ACAT) II project.⁸⁷

3.28 Defence advised the ANAO in October 2021 that:

As outlined within the IAR Policy Statements ... 'IARs of programs are conducted on request and undertaken in support of a risk based management approach, generally coinciding with a major event or decision point.' Major decision points associated with the SEA1445-1 Additional CCPB [Cape class patrol boat] project have been limited since establishment of the acquisition contract through non-regular means (as have been articulated and are well understood) in April 2020, noting that the project was focused on purchasing additional vessels and production was underway at the time of contract establishment. Further ... due to the impacts of COVID-19 the IAR program has been required to reprioritise the forward work program to align with resources and departmental priorities. This has led to significant deferment of some reviews.

While the IAR team is aware of the SEA1445-1 Project the Project has not sought for an out-of-work-program IAR to be conducted and, due to the reasons indicated above, an IAR has yet to be included within the forward work program.

Arrangements to provide assurance on vessel construction

3.29 On 17 August 2020, Defence engaged an engineering firm (Jacobs Australia Pty Ltd) as a third-party provider to undertake production monitoring services.⁸⁸ As per the contract, build

86 Auditor-General Report No.19 2020–21 *2019–20 Major Projects Report*, paragraphs 1.11-1.12. In particular, IARs help draw risks and issues to the attention of the Deputy Secretary, CASG.

87 The ACAT framework is Defence's method for categorising acquisition projects. It is based on strategic significance, project and schedule management complexity, and levels of technical difficulty, operating and support and commercial arrangements. Higher complexity projects with a greater degree of strategic significance are assigned an ACAT I level, with low complexity minor acquisitions assigned an ACAT IV level. ACAT II projects are Major Capital Equipment acquisitions that are strategically significant to Defence, normally characterised by high levels of complexity in several of the following categories: project and schedule management complexity, technical difficulty, operating, support arrangements and commercial arrangements.

88 Production monitoring services include schedule monitoring and physical configuration audits. Defence varied existing contracts with Jacobs under the SEA 3036 (Guardian class) program to include production monitoring for the SEA 1445-1 project. The Production Monitoring Team is expected to provide weekly reports for each project including, for example, advice on key points, notable events, problems, risks and issues in relation to construction and verification activities. The additional cost of this variation was \$901,365 (GST inclusive), for a revised contract total of \$6.7 million (GST inclusive).

certification and build classification is provided primarily by the assigned Classification Society, in this case DNV.⁸⁹

3.30 Prior to approval and signature of the contract variation, Jacobs Australia Pty Ltd performed production monitoring work on Austal's construction of the Cape class boats as the Defence representative. This work included confirmation that Austal had met the relevant criteria for payment under milestone payment one of the contract (paid to Austal in late May 2020).

3.31 Defence informed the ANAO that its Naval Construction Branch is not involved with the SEA1445-1 Project and therefore has no agreements or formal relationships in place'.⁹⁰ Defence documentation indicates that Naval Construction Branch confirmed arrangements for the production monitoring function to be performed by third-party contractors as appropriate, as Naval Construction Branch 'does not have a footprint in WA [Western Australia] at this time so is therefore not geared to offer an alternative approach'.

Project management documentation

3.32 The Defence Capability Manual⁹¹ identifies a set of key documents that are required to be in place to support project governance. The Manual notes that this documentation 'supports strong governance, by recording advice and agreements, plans, decisions and directions at various levels and by differing organisational contexts'. It defines the acquisition phase as:

The phase of the capability life cycle in which the government approved capability is procured by one or more delivery groups and delivered to the capability manager in accordance with the product delivery agreement and integrated project management plan.⁹²

3.33 CASG also has a Project Management Manual which describes the framework in which CASG undertakes project related activities to acquire, introduce, manage and, where agreed, upgrade Defence capabilities. The manual identifies key project management documentation.

Product Delivery Agreement (Materiel Acquisition Agreement)

3.34 A Product Delivery Agreement (PDA) — also known as the Materiel Acquisition Agreement (MAA) — is to be established for any Defence project where CASG is receiving funding to support

89 Prior to 1 March 2021, DNV was known as DNV-GL. A Classification Society establishes and maintains technical standards for the construction and operation of ships and offshore structures. Defence advised the ANAO on 1 October 2021 that the evolved Cape class boats will be introduced into service under the Defence Seaworthiness Management System and that DNV's role in providing build assurance is one part of seaworthiness assurance activities.

90 Defence's Naval Construction Branch Enterprise Strategy "First Steps" (29 April 2019, p.6) states that: 'In response to the Naval Shipbuilding Plan, the Naval Construction Branch (NCB) has been established to become: the Australian storehouse of naval ship building expertise, the manager of naval ship building infrastructure, and to provide onsite oversight of ship construction activity on behalf of the ship/submarine acquisition programs and the Navy.'

91 Previously known as the Capability Life Cycle Manual. There were four versions of the Defence Capability Manual applicable to the Cape class patrol boat acquisition: January 2020; June 2020; October 2020; and December 2020. When reviewing key governance and decision documents required, this report refers to the relevant Capability Lifecycle Manual applicable at the point at which the key governance documents should have been developed.

92 The acquisition phase commences with government approval to commence acquisition activities and concludes when the products have been delivered and introduced into service. This includes appropriate testing and evaluation to ensure the system's safety and suitability for service and that the system addresses the endorsed need.

and/or deliver elements of a project. Defence's internal guidance required that 'an MAA must be signed within 45 days of government (or Ministerial approval) or for projects that have been presented for the Investment Committee for Gate 0 approval'.

3.35 As of 1 December 2021 — 20 months after government approval for the acquisition was given on 6 April 2020 — Defence had not approved a PDA/MAA between Navy and CASG for the acquisition of the six evolved Cape class boats. On 1 October 2021 Defence advised the ANAO that:

In the absence of a fully endorsed MAA the project loads and reports against the risk and milestones as they appear within the initial version of the MAA (which is currently in circulation for endorsement).

Integrated Project Management Plan

3.36 CASG's Project Management Manual⁹³ notes that the Integrated Project Management Plan is a key project management document which, following government approval of a project⁹⁴:

... provides direction for the successful delivery of the required products and services in the context of overarching capability requirements, Fundamental Inputs to Capability Integration and product delivery for the project.

3.37 The Integrated Project Management Plan provides the basis for all departmental stakeholders to agree their commitment of resources, against defined timelines, to achieve the agreed outcomes of the project and the integration of the capability. This includes ensuring the test and assurance activities, such as operational test and evaluation, are fully planned out to support the declarations of Initial Operational Capability and Final Operational Capability.⁹⁵

3.38 As at 1 December 2021, Defence had developed a draft Integrated Project Management Plan for the project, which had not been approved.

3.39 In the absence of an approved Product Delivery Agreement (Materiel Acquisition Agreement) and Integrated Project Management Plan, and with no independent assurance reviews conducted to date, Defence and its senior leaders have not had the benefit of the full suite of inputs which contribute to providing assurance that capability requirements are being successfully delivered by an acquisition project.

Arrangements for managing risk

3.40 The Defence Capability Manual notes that governance arrangements in the acquisition phase include arrangements for 'risk management to ensure emerging risks are identified and appropriately treated'. In an internal directive, the Deputy Secretary CASG states that 'Managing risk and leveraging opportunity in acquisition and sustainment are key tasks of the Capability

93 Version 4.2, dated 12 May 2021.

94 The Integrated Project Management Plan is initially established to govern project development activities as they are brought forward for endorsement and approval.

95 Defence defines Initial Operational Capability (IOC) as the capability state relating to the in-service realisation of the first subset of a capability system that can be employed operationally. Final Operational Capability (FOC) is defined as the capability state relating to the in-service realisation of the final subset of a capability system that can be employed operationally. Declaration of IOC and FOC is made by the Capability Manager, supported by the results of operational test and evaluation and declaration by the relevant Defence delivery group(s) that the fundamental inputs to capability have been delivered.

Acquisition and Sustainment Group (CASG) in delivering capability outcomes to Capability Managers.’

3.41 The ANAO examined Defence’s implementation of arrangements for the management of project risks and issues, focusing on arrangements adopted by the project team and the capability owner.

Project Team

3.42 A risk management plan for the project was approved on 27 April 2021, twelve months after contract signature. The plan outlines the governance and reporting arrangements around the management of risks and issues for the project, including responsibilities, identification and analysis, and reporting and monitoring.

3.43 Defence informed the ANAO that as at early August 2021, three internal risk meetings had been held since contract signature, two of which pre-dated the approval of the risk management plan.

3.44 Defence’s mandated risk management tool (called Predict!) is used to record, describe and rate project risks for the project, and Defence established a risk log for the project in July 2020. The July 2021 risk log included 21 risks and issues, with the following residual risk ratings:

- two issues were rated ‘extreme’⁹⁶;
- two risks were rated ‘high’⁹⁷;
- 12 risks were rated ‘medium’; and
- five risks were rated ‘low’.⁹⁸

3.45 The ANAO’s review of governance meeting minutes indicated that risks with residual risk ratings of ‘extreme’ or high’ (as documented in the risk log) were discussed at one or more of the governance meetings and/or in Austal’s progress reviews. It was unclear from the minutes or meeting documentation reviewed whether the risk log was used to inform those discussions.

3.46 As part of the acquisition contract, Austal has produced and delivered a description of its risk management processes and procedures within its Project Management Plan, and has maintained a risk register for the duration of the contract. Records indicate that risks and issues were regularly discussed at Progress Review Meetings between Defence and Austal.

Capability owner

3.47 Navy is the capability owner and uses CapabilityOne⁹⁹ for the management of capability risks and issues. At July 2021, two active risks and one proposed risk (in draft form) were recorded in CapabilityOne for the evolved Cape class capability. The two active risks related to:

96 The two risks rated as ‘extreme’ were for production workforce delays and the delay to schedule due to an aluminium quality issue (discussed at paragraphs 3.78-3.105).

97 The two risks rated as ‘high’ were for the sea boats purchased for the evolved Cape class and whether they would meet Navy’s contemporary stability standards, and that the Commonwealth may not receive the intellectual property rights required under the evolved Cape class contract.

98 This list excludes four risks recorded in Predict! which Defence informed the ANAO were not approved risks and therefore should not be considered as active risks. The four risks had a residual risk rating of ‘medium’.

99 CapabilityOne is a web-based application used in support of Defence’s One Defence Capability System.

- Delay in material release or reduced capability at material release due to required Government Furnished Information and Equipment not being provided.
- Introduction into service delayed due to capability lifecycle governance not being established effectively including FIC (fundamental inputs to capability) coordination.

Monitoring and reporting arrangements

3.48 CASG's policy on project management notes that: 'A robust and transparent reporting framework ensures the efficient dissemination of key project performance information and enables timely decision-making at all levels.'

Project reporting – Project Performance Review Information Platform

3.49 Defence utilises the Project Performance Review Information Platform (PPRIP) to report on the performance of the SEA-1445 project.¹⁰⁰ The PPRIP is a web-based tool which Defence uses to upload standardised project data from its existing financial and risk systems (such as BORIS, ROMAN and Predict!) to obtain an overview of project data. The platform reporting can also use information from an MAA to support monitoring of a project's performance against agreed deliverables (such as schedule and cost).

3.50 The ANAO reviewed monthly PPRIP reports for the period February to October 2021. As shown in Table 3.3 below, the PPRIP for SEA 1445-1 includes ten key performance measures, with outcomes for nine key performance measures reported on and supported with commentary from the project team.

3.51 There were no outcomes reported for the 'risk' key performance reporting measure during this period.¹⁰¹

3.52 As Defence is yet to finalise the Materiel Acquisition Agreement, reporting through the PPRIP is affected.¹⁰² As discussed in paragraph 3.35, on 1 October 2021 Defence advised the ANAO that in the absence of a fully endorsed MAA, the project loads into PPRIP and reports against the risk and milestones as they appear within the initial version of the MAA, which Defence advised was in circulation for endorsement.

100 On 3 August 2020 the PPRIP replaced Defence's existing Monthly Reporting System as Defence's primary system for reporting on the performance of its acquisition projects. Defence informed the ANAO that it did not set up reporting for SEA 1445-1 in the Monthly Reporting System 'as the project was not mature enough in May and June 2020 (contract only signed 30 April 2020).'

101 Defence informed the ANAO in August 2021 this was due to connectivity issues between the PPRIP and the project's Predict! risk log. Defence further noted that workarounds, such as Predict! extracts, were used by the project to supplement the information from PPRIP.

102 The MAA is the data source for reporting through PPRIP on the following: project attributes; schedule milestone performance; cost/whole of project life; cost/whole of life by year; scope.

3.53 The ANAO was further advised by Defence that PPRIP reports are used to support Project Performance Review¹⁰³ discussions with the project managers and the First Assistant Secretary, Ships.¹⁰⁴

3.54 Reporting to senior internal and external stakeholders includes CASG reports on key major acquisition projects and key sustainment products. Until June 2020, this reporting was through the Quarterly Performance Report (QPR).¹⁰⁵ Subsequent to the QPR, SEA1445-1 was reported on as a key acquisition project in the Project and Sustainment Report (PSR) for the period July 2020 to September 2020. There has been no subsequent PSR reporting on the project.

103 Project Performance Reviews are managed monthly conversations between Branch Heads and Project managers, with a focus on resolving issues and managing risks.

104 Defence advised the ANAO on 1 October 2021 that review discussions were originally (in 2020) held with FAS Ships with a view to informing on the progress of SEA1445-1 in the establishment phase, so as to capitalise on the knowledge base within Ships Division. Defence further advised that while the project was and is currently being staffed with personnel from within Ships Division and physically located with other Ships Division projects, it is responsive to Head Maritime Systems, is a Maritime Systems Division project and progress and performance reporting has been aligned with the reporting lines of the Assistant Secretary Specialist Ships and the Head Maritime Systems.

105 The SEA 1445-1 project was not included in the last QPR, covering the period April to June 2020, though the acquisition of the six evolved Cape class boats is mentioned in relation to the sustainment of the Armidale class boats and notable achievements for the Maritime Division over that reporting period.

Table 3.3: SEA 1445-1 reporting, Project Performance Review Information Platform, February to October 2021

Performance metric	February 2021	March 2021	April 2021	May 2021	June 2021	July 2021	August 2021	September 2021	October 2021
Risk	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Schedule milestone performance	Red	Red	Red	Red	Red	Red	Red	Red	Red
Progress performance curves	Green	Green	Green	Green	Green	Green	Green	Green	Green
Finance	Green	Green	Green	Green	Green	Green	Green	Green	Green
Fundamental Input to Capability	Green	Green	Green	Green	Green	Green	Green	Green	Green
Interdependencies	Green	Green	Green	Green	Green	Green	Green	Green	Green
Scope or Capability	Amber	Red	Red	Red	Red	Red	Red	Green ^b	Red
Workforce Plan	Amber	Amber	Amber	Amber	Amber	Amber	Green ^a	Green	Amber
Commercial	Green	Green	Green	Green	Green	Green	Green	Amber ^c	Green
Achievements and concerns	Green	Green	Green	Green	Green	Green	Green	Green	Green

Note a: Change in status of 'Workforce Plan' reflects reduction in vacant positions on the project team to no vacant positions.

Note b: Defence advised the ANAO in October 2021, in relation to the reporting for September 2021, that 'Delays as a result of COVID 19 are no longer an issue, overtaken by confirmed delays to acceptance due to non-compliant aluminium. Acceptance schedule for all vessels delayed.'

Note c: Defence advised the ANAO in October 2021, in relation to 'Commercial', that 'due to the two reported schedule delays and the Supply issues associated with the Satellite Communication (SATCOM) system there are some commercial issues to be resolved between the Project and Austal...The Project continues to work with Austal to understand the impacts and likely commercial issues/contractual remedies associated to the work force issues and delays to Acceptance Milestones. In addition the project is working with Austal to resolve a Government Furnished Equipment issue with the supply of SATCOM equipment, with the Commonwealth understanding that this equipment should be supplied by Austal.'

Source: Defence PPRIP.

Contract monitoring and reporting – Contract Status Reports

3.55 Under the contract, Austal is required to provide Defence with Contract Status Reports containing information on: progress; planned activities; and problems and risks. Austal is required to provide these reports to Defence every month prior to the acceptance of the first boat, with contract status reports to be provided every two months thereafter.¹⁰⁶

3.56 As of November 2021, Austal had provided Contract Status Reports to Defence on 15 occasions, meeting the contractual requirements.¹⁰⁷

3.57 Defence provided review comments to Austal on each of the Contract Status Reports submitted. ANAO review of Defence's comments indicated that Defence consistently noted issues with the quality of the reports, including: the accuracy and consistency of the information reported; compliance with requirements under the contract; and the level of detail and information provided.

3.58 Defence feedback on the Contract Status Report for May 2021 requested that Austal include relevant progress information pertaining to Austal's DISP membership in future contract status reports.¹⁰⁸ Prior to this, Defence had not taken steps to confirm that contracted DISP requirements had been met.

Contract Master Schedule

3.59 Contract Status Reports are to include an updated Contract Master Schedule and advice on progress against the Australian Industry Capability (AIC) plan.

3.60 Following Defence's approval of Austal's Contract Master Schedule in July 2020¹⁰⁹, Austal has submitted multiple updates of the Contract Master Schedule to Defence as part of the Contract Status Reports.¹¹⁰

3.61 Defence is required to approve all updates to the Contract Master Schedule, to ensure it is in accordance with the requirements of the contract. Of the updates reviewed by Defence the majority were 'approved' or 'approved, with minor omissions or defects'.

3.62 An update to the Contract Master Schedule, as a data item under the contract, cannot be approved if it: is not clearly understandable; does not provide adequate detail; is inconsistent with the Contract, including related data items; does not meet the objective of the data item; or where previously identified omissions or defects have not been addressed satisfactorily.

3.63 Defence informed the ANAO that the last approved Contract Master Schedule remains extant until an update is approved.

106 Under the contract, acceptance of the first boat was originally scheduled for 17 September 2021. This has been revised three times due to delays, with the most recently advised date of delivery being 11 March 2022. These delays are discussed further at paragraphs 3.78–3.105

107 One Contract Status Report covered two reporting periods, as agreed with Defence.

108 See paragraphs 3.7–8 for further discussion of DISP issues, including the ANAO performance audit of DISP in progress at that time.

109 The final Contract Master Schedule was submitted to Defence but was not submitted as per contract requirements.

110 Updates are submitted as part of the Contract Status Report. As noted above, one Contract Status Report covered two reporting periods, as agreed with Defence. Defence's review comments on the Contract Status Reports noted on several occasions that the reporting periods for the Contract Status Report and Contract Master Schedules did not always align as required.

Australian Industry Capability (AIC)

3.64 The Contract Status Reports submitted by Austal have included reporting on progress against the AIC plan.¹¹¹

3.65 As at 12 October 2021, Austal reported an AIC Local Industry Activity cumulative total expenditure of \$43.2 million. This was \$85,830 less than the forecast.¹¹² While the Contract Status Reports do not include information on jobs, the reporting requirements under the relevant part of the contract require Austal to provide a human resources report, including details of the actual versus planned head count (both total and by skill category) and any issues with respect to Key Persons and staffing levels. Austal has reported on this in each Contract Status Report as required.

3.66 Under the contract, Austal is required to deliver an updated AIC plan, or confirm the plan's continuing accuracy in writing, on a periodic basis after contract signature, to incorporate any changes to Australian industry opportunities. On 21 October 2021 Austal wrote to Defence confirming the AIC plan's continuing accuracy and advising that delays would likely impact the values in the plan, with an updated plan to be provided once the required changes were known.

Contract Progress Meetings

3.67 Under the contract, Contract Progress Meetings must be conducted every three months. They are co-chaired by a Commonwealth representative and the Contractor's Project Manager. As required, four meetings were held between July 2020 and July 2021.

3.68 Contract Progress Meetings have discussed: risks and issues with the achievement of contract requirements including resourcing, the aluminium quality issue and late equipment; quality and timeliness of data item deliverables under the contract, including Contract Status Reports; issues with the two leased Cape class boats in Navy service; engineering changes; and project updates.¹¹³ Action items have been recorded for each meeting, with responsibility assigned to either a Defence or Austal representative.

External reporting

3.69 The evolved Cape class patrol boats are among the 'Top 30' Defence acquisition products by forecast expenditure for 2020–21 and 2021–22, with information on acquisition expenditure publicly reported by Defence in its Portfolio Budget Statements, Portfolio Additional Estimates Statements and Annual Report.

3.70 Reporting has included: a description of acquisition activity; estimated expenditure; actual expenditure; the variation between estimated and the actual expenditure; and some explanation of the variation between estimates in the Portfolio Budget Statements and Portfolio Additional Estimates Statements.

111 This included Austal providing reporting on AIC prior to approval of the AIC plan.

112 Austal reporting includes forecast and actual values before 30 April 2020 contract signature.

113 For example, on engineering, integrated logistics support, Lifecycle Upkeep Sustainment Intelligence (LUSI) and configuration management.

Is Defence managing project milestones effectively and supporting the delivery of capability requirements?

Defence has undertaken an appropriate range of activities to date to manage project milestones, with the intent of supporting the delivery of capability requirements. Defence records indicate that as at August 2021, delays of 26 to 35 weeks are projected for boat delivery compared to contracted milestones, due to the contractor's need to undertake rectification work following the use of defective aluminium and production workforce inefficiencies reported by the contractor. As of July 2021 net additional costs arising from projected delays, along with OPV delays, have contributed to a Defence estimated increase of \$43.9 million to OPV transition costs. This has resulted in the planned extension of service of the Armidale class and a reduced in-service period for the evolved Cape class, demonstrating the consequential effect of project schedule delays to ADF capability and the Australian Government's naval shipbuilding strategy. As noted above, Defence's acquisition contract for the six evolved Cape Class patrol boats includes provisions for the payment of liquidated damages.

3.71 As the contract manager, Defence is responsible for managing the contract to deliver milestones on time, on budget and for the contracted capability. Delivery in line with contracted timeframes, budgets and capability supports the achievement of expected value for money outcomes and supports Navy's capability transition planning.

3.72 To assess whether Defence is managing the project effectively, the ANAO examined:

- the current status of delivery against project milestones and whether the project was on time and on budget; and
- whether Defence had appropriately managed risks and issues which may impact the achievement of project milestones and Navy's transition planning for patrol boat capability.

Delivery against project milestones

3.73 As at 10 December 2021, 12 contractual milestones were due (see Table 3.1 above). Associated payments totalled approximately \$197,859,361 (GST exclusive).¹¹⁴

3.74 Since contract signature, Austal has claimed payment against eight of these milestones, with Defence approving all for payment.¹¹⁵ The ANAO's review of the eight milestone payments indicated that:

¹¹⁴ All milestone payment amounts (scheduled and actual) are reported on an Australian dollar equivalent basis, GST exclusive.

¹¹⁵ Milestone 7 – Boat 2 Milestone B was due on 21 June 2021 but was not achieved on time, and is currently planned to be met on 11 February 2022 due to delays associated with the defective aluminium. Milestone 9 – Acceptance Boat 1 was due on 17 September 2021 but it was not achieved on time, and is currently planned to be met on 11 March 2022 due to delays associated with the defective aluminium and production workforce inefficiencies. Milestone 10 – Boat 3 Milestone B was due on 18 October 2021 but it was not achieved on time, and is currently planned to be met on 28 January 2022 due to delays associated with the defective aluminium. Milestone 12 – Acceptance Boat 2 was due on 10 December 2021 but was not achieved on time and is currently planned to be met on 22 July 2022 due to delays associated with the defective aluminium and production workforce inefficiencies.

- four boat commencement milestones (Milestone A payment) and the advance equipment order milestone were claimed on schedule¹¹⁶, two of which included adjustment claims made two and five months after the initial claim¹¹⁷;
- two further boat commencement milestones were subject to a notification of delay and submitted within two weeks of the contracted schedule date; and
- one boat launch milestone was claimed late, 70 days after the date nominated by Austal in April 2021 as part of its notification of delays resulting from the use of defective aluminium (discussed below).

3.75 Four of the 12 scheduled milestone payments were not claimed on time due to the delays encountered in the construction of the first two evolved Cape class boats (Boats 1 and 2) as a result of the use of defective aluminium. Further delays to scheduled milestone payments are anticipated, relating to the use of defective aluminium and workforce productivity issues (discussed at paragraphs 3.78-3.105).

Payments for milestones achieved

3.76 As at 1 December 2021 Defence had paid approximately \$132.4 million to Austal for the achievement of eight scheduled contract milestones, which had a contracted value of approximately \$133 million. There was a variance of \$558,939 between the scheduled total payment amount for the eight milestones paid and the total payment amount, which was attributable to exchange rate fluctuations.

Table 3.4: Milestones claimed by Austal as at 1 December 2021, including scheduled versus actual milestone claimed dates

Milestone	Scheduled date ^a	Claimed date	Difference (days)
1. Boat 1 Milestone A	30 April 2020 ^b	1 May 2020	1
2. Advance Equipment Orders	1 June 2020	16 June 2020	15
3. Boat 2 Milestone A	27 July 2020	4 August 2020	8
4. Boat 3 Milestone A	23 November 2020	24 November 2020	1
5. Boat 4 Milestone A	15 March 2021	15 March 2021	0
6. Boat 1 Milestone B	9 April 2021	24 September 2021	168
8. Boat 5 Milestone A	5 July 2021	8 July 2021	3
11. Boat 6 Milestone A	25 October 2021	25 October 2021	0

Note a: As at contract signature, 30 April 2020.

Note b: Contract effective date.

Source: ANAO analysis of Defence data.

116 One milestone payment claim, Milestone 1 — Boat 1 Milestone A was resubmitted at Defence's request due to lack of evidence to support the meeting of exit criteria.

117 In respect to the adjustment claim for Milestone 4 — Boat 3 Milestone A, Austal's advice to Defence noted that the claim was being made outside the timeframe specified in the contract due to the time taken for Austal and the Commonwealth to resolve a contract change proposal.

3.77 As previously discussed, Defence amended an exit criterion for the payment of Milestone 3 (Boat 2, Milestone A) to accommodate the delay in the approval of the AIC plan.¹¹⁸ The criterion (Approval of the AIC plan) was moved to the exit criteria for the payment of a later milestone (Boat 3, Milestone A). As noted in paragraph 3.14, the AIC plan was approved by Defence on 20 November 2020 and a public AIC plan was published on the Defence website on 5 August 2021 in accordance with the requirements of the AIC program. To strengthen its ability to manage contracted deliverables and achieve the objectives of AIC policy, Defence should confirm tendered AIC commitments with vendors during the contract negotiation phase of procurements.

Management of risks and issues

3.78 As discussed in paragraphs 3.40–3.47, Defence has established a risk management process for managing project risks and issues, including utilising a risk management tool to identify, manage and monitor project risks and issues.

3.79 To date, two key issues have caused delays in the evolved Cape class patrol boat project:

- the use of defective aluminium in the construction of the first two boats; and
- production workforce shortages.

3.80 These have been documented by Defence in its risk management log as issues with a residual risk rating of 'extreme'.

3.81 Delays in the construction of early boats are expected to flow-through to the construction of later boats. Delays to the acceptance milestones for Boats 1 to 6, as at July 2021, are presented in Table 3.5 below.

Table 3.5: Delays to the acceptance milestones for Boats 1 to 6, as at July 2021

Acceptance milestone ^a	Contracted acceptance milestone dates	Aluminium certification related delays — revised dates ^b	Production workforce related delays — revised dates ^c	Total delay from contracted milestone dates (weeks)
Boat 1	17 September 2021	17 December 2021	11 March 2022	25
Boat 2	10 December 2021	01 April 2022	22 July 2022	32
Boat 3	08 April 2022	01 July 2022	4 November 2022	30
Boat 4	12 August 2022	30 September 2022	10 March 2023	30
Boat 5	25 November 2022	13 January 2023	23 June 2023	30

¹¹⁸ See paragraphs 3.11–3.12 for milestone payment exit criteria arrangements, and paragraphs 3.14–3.15 on the AIC plan.

Acceptance milestone ^a	Contracted acceptance milestone dates	Aluminium certification related delays — revised dates ^b	Production workforce related delays — revised dates ^c	Total delay from contracted milestone dates (weeks)
Boat 6	24 March 2023	14 April 2023	29 September 2023	27
Final acceptance	25 March 2024	12 April 2024	Not provided	—

Note a: Austal's 3 August 2021 notification on production workforce related delays provided information on contract acceptance milestones only and did not provide information on other milestone payments (including Final acceptance). Defence advised the ANAO in October 2021 that the new final acceptance date would be 12 months from Boat 6 acceptance and that Defence anticipated that Austal would advise this in due course. Austal's 29 April 2021 advice to Defence on delays related to aluminium certification provided information on all contracted milestones.

Note b: As notified to Defence by Austal on 29 April 2021.

Note c: As notified to Defence by Austal on 3 August 2021.

Source: ANAO analysis of Defence documentation.

Aluminium certification issues and risks

3.82 In late October 2020, Austal notified Defence of defective five-millimetre aluminium plate¹¹⁹ used in the construction of the first two boats, and that further testing was underway. Austal advised that there would be an impact on its ability to achieve contracted milestones as 'significant remediation works' were required for the first two boats.¹²⁰

3.83 During November and December 2020 Defence engaged with Austal on multiple occasions, including through workshops, to understand the aluminium issue, proposed remediation work and anticipated delay to delivery milestones. Defence also used these engagements to communicate its expectations and suggest improvements, including on the quality of information provided and approach to remediation and rescheduling. On 4 December 2020, Austal provided advice to Defence on the anticipated achievement of acceptance milestones as well as information on steps being taken to minimise the delay.

3.84 On 15 December 2020, Austal further advised Defence of defects with four- and six-millimetre aluminium plate used in the construction of the first two boats.¹²¹ Austal provided further advice to Defence on 18 December 2020 on the anticipated achievement of acceptance milestones.

119 Defence records indicate that the defective aluminium was subject to sensitisation or a material flaw resulting from inappropriate heat treatment, whereby the aluminium becomes more susceptible to corrosion at the intersection of the grains of the metal, which can lead to cracking. This risk is heightened in areas of high stress and after prolonged periods of service at elevated temperatures, particularly where seawater is involved. The defective aluminium was also used in the construction of three Guardian class patrol Boats, though to a lesser extent than on the evolved Cape class.

120 Austal's advice noted that of the 58 five-millimetre aluminium sheets received by Austal and that were subject to recall, only five had not been incorporated into the first two boats.

121 Austal's initial advice on 13 November 2020 noted that no similar anomalies were identified in batches delivered from other mills or identified on other plate sizes from the same aluminium manufacturing mill.

3.85 In mid-December 2020, Defence's Head Maritime Systems initiated a technical review into the aluminium issue¹²², with:

... the aim to be clear about the full picture as to how this has occurred and how to remediate to minimise quality and schedule impact and for the CoA [Commonwealth of Australia] to be confident moving forward in any revised plan or action from Austal.

3.86 The technical review was initiated in late January 2021¹²³, with the final report provided to Defence on 18 February 2021. Following the completion of the technical review Defence was satisfied that the defective material had been identified and that a satisfactory testing regime and remediation plans to prevent recurrence and address required rework had been put in place. After receiving the report, Defence also engaged with the classification society (DNV), in April and May 2021, on how to minimise the risk of similar cases occurring in the future.

3.87 Between October 2020 and late April 2021, Austal reported to Defence that it undertook the following activities as part of its remediation effort and to minimise further schedule delays:

- 46,654 hours of remediation work;
- utilisation of sub-contractors, for example in the fabrication of units, to free up Austal fabricators, workspace and reducing constraints in production flow; and
- increasing production activity through the use of overtime, extension of labour hire resources, changes in shift arrangements, working through the 2020 Christmas shut-down period, and recruiting to increase the production workforce.

3.88 On 29 April 2021, Austal provided Defence with advice on the anticipated achievement dates of contracted milestones. The advice indicated that for the 15 remaining contracted milestones, all but two would be delayed.¹²⁴ The advice also included structural audits conducted by Austal, indicating that the defective plate was distributed across a large part of the hulls for the first two boats.

3.89 As at October 2021 Austal had not made a postponement claim under the acquisition contract in relation to the remediation work.¹²⁵ Defence advised the Minister for Defence on 11 February 2021 that based on a 12 to 16 week delay for the first two boats:

The schedule delay may incur additional Armadale class patrol boat sustainment costs. Confirmation of costs will occur once Austal finalise the total schedule impact for all 6 evolved Cape class patrol boats. At this stage the additional Armadale sustainment costs are estimated to be approximately \$1.8million FY 21/22 and \$1.2million FY 22/23.

Production workforce issues and risks

3.90 On 9 June 2021, Austal advised Defence of further schedule delays due to production workforce issues:

122 This followed a teleconference held on 18 December 2020 between Austal and Defence attended by Defence's Deputy Secretary National Naval Shipbuilding and Head Maritime Systems.

123 The technical review occurred in accordance with section 11.7.1 of the contract.

124 The other five milestones had either been met and payments made, or Austal had notified completion.

125 The acquisition contract with Austal for the evolved Cape class boats is fixed-price. Mechanisms are included in the contract to allow for postponement claims to be made where appropriate. Defence advised the ANAO in October 2021 that Austal had reserved its rights to make a postponement claim in the future in relation to this issue.

Austal is facing significant challenges in the recruitment of skilled trades in order to mitigate productivity inefficiencies being experienced across the program due to COVID-19 social distancing requirements. The drivers for the resources shortage are multi-industry and state-wide, and with the shortages directly related to the COVID-19 pandemic and the Federal and WA [Western Australian] Government border restrictions related thereto.

3.91 Austal also provided Defence with the 'likely anticipated ranges of achievement of the Acceptance Milestone dates' for all six evolved Cape class boats, with dates to be further refined as 'Austal continues to investigate the cause and impacts of the delay'.

3.92 On 3 August 2021, Austal provided Defence with further advice on the anticipated achievement dates of contracted milestones.

3.93 The ANAO's comparison of the date ranges provided by Austal against contracted dates indicates that delays of between six and nine months are anticipated for all six boats' acceptance milestones (see Table 3.5 above).¹²⁶

3.94 On 1 July 2021, in response to Austal's June 2021 advice, Defence's Head Maritime Systems advised the Deputy Secretary National Naval Shipbuilding of the delays. In response, the Deputy Secretary requested a 'quick analysis on the outcome of the value for money assessment made at the time of the offer if the revised dates are used instead of the contracted dates.'¹²⁷ Defence advised the ANAO on 1 December 2021 that the additional value for money assessment had not been undertaken.

3.95 The Chief of Navy was advised, in a 14 July 2021 decision brief on the revised transition plan, that the estimated cost to undertake the activities specified in the revised transition plan was \$43.9 million, 'after offsets'.

3.96 Defence advised the ANAO in October 2021 that:

There are no stop payment milestones in this Contract (which typically prevent payment of later Milestones due to the contractor not achieving an earlier Milestone).

3.97 The first acceptance milestone, which was for acceptance of Boat 1, was due on 17 September 2021 and was not met by Austal due to the delays discussed above. The ANAO sighted evidence that Defence had taken steps under the contract to address this issue with Austal. Under the conditions of contract, Defence has capped Austal's liability for liquidated damages. The Liability Risk assessment attached to the section 23 commitment approval indicates that Defence calculated a liability amount based on the maximum delay that the project would accept.

3.98 Defence advised the Minister for Defence of the additional schedule delays on 26 July 2021, noting that 'Austal is investigating to better understand the contributors to the production workforce related delays and provide further information' and that 'Austal are contractually responsible for the maintenance and performance of their workforce and costs relevant to this, and measures taken by Austal to reduce schedule impact are borne by Austal'. The advice to the Minister also noted 'flow-on implications to Navy's Capability Transition Plan'. Defence did not

126 The ANAO's review took into account the previously adjusted acceptance milestone dates (involving delays of three to seven months) due to the aluminium certification issue.

127 Defence advised the ANAO on 25 October 2021 that 'While a further VFM assessment has been scoped (concept and potential execution path) this has not yet been executed. Plans to perform additional VFM work are currently under review.'

advise the Minister that consequential changes had already been made to the transition plan and approved by the Chief of Navy (discussed at paragraphs 3.99–3.105), or provide information on the cost implications of the expected delays.

Impact of the delays to the timely delivery of patrol boat capability to Navy

3.99 On 14 July 2021, the Chief of Navy revised¹²⁸ the Patrol Force Capability Transition Plan in light of delays to the delivery schedule for all six evolved Cape class patrol boats and the first two Arafura class Offshore Patrol Vessels (SEA 1180-1).¹²⁹ This involved changes to the planned use and retirement of Navy's Armidale class patrol boats.¹³⁰

3.100 The revised transition plan was informed by Austal's June 2021 advice of schedule delays for the evolved Cape class.

3.101 To account for the schedule delays and maintain directed levels of vessel availability, revisions to the August 2020 transition plan primarily involved changes to the transition and disposal plan for the Armidale class patrol boats. These changes included:

- reordering the planned withdrawal dates of Armidale class boats to 'ensure effective use of major maintenance milestones and certification periods';
- conducting additional maintenance periods, and HMAS *Childers* and *Broome* (Armidale class boats) undergoing the full 60 monthly maintenance period;
- extending the planned withdrawal dates for seven Armidale class boats, with extensions of two to 21 months¹³¹; and
- amending the disposal strategy for Armidale class boats approved by the Chief of Navy in February 2021.¹³²

3.102 The transition plan also outlines:

- delays to the introduction into service¹³³ of the six evolved Cape class boats — of between five and nine months; and

128 On 17 August 2020, the Chief of Navy approved the Patrol Force Capability Transition Plan. The plan reflected the delivery schedule in the Austal acquisition contract (April 2020) for the evolved Cape class boats.

129 In May 2021, Navy was advised by CASG of a six-month delay for the first two Arafura class vessels (OPVs): delivery of *Arafura* moved from December 2021 to June 2022; and delivery of *Eyre* moved from September 2022 to March 2023. There were no changes to the scheduled delivery of the remaining 10 OPVs.

130 As a result of the delays in the delivery of the evolved Cape class boats, Defence has had to negotiate a delay in the delivery of their sea boats from Britton Maritime Systems Pty Ltd.

131 There are currently 12 Armidale class patrol boats in-service. HMAS *Pirie* (II) was decommissioned on 26 March 2021.

132 Chief of Navy approved the disposal strategy for the Armidale class on 8 February 2021. The strategy had two phases. Phase one retired five boats, with usable parts to be harvested to sustain the remaining fleet. Phase two involved five disposal options for the eight remaining boats.

The strategy also includes HMAS *Maitland* being identified for disposal by sale/transfer to Austal, to conduct a proof of concept for a Large Unmanned Surface Vehicle. This was approved in principle by Chief of Navy on 30 May 2021. HMAS *Maitland* is scheduled for withdrawal from service in April 2022.

133 Introduction into service dates occur after the boats have been accepted from the contractor and have undergone an acceptance, sea release and operational testing period. The August 2020 transition plan provided for a two-month period between acceptance and introduction into service. This was extended to a three-month period in the July 2021 transition plan.

- extended withdrawal dates for two of the six evolved Cape class boats — by one month for the first and last boats. As a result, the in-service period for the boats is reduced.

3.103 These changes potentially affect the value for money obtained by Defence in the acquisition, especially after taking into account the additional costs associated with Armidale class boats remaining in service.¹³⁴

3.104 As part of approving the revised Patrol Force Capability Transition Plan, the Chief of Navy requested the following additional actions:

- active management and quarterly updates to the Patrol Force Capability Transition Plan in order to optimise all inputs while maintaining the availability of 12 platforms, with additional capability (and cost) to be avoided; and
- increased visibility of the management of sustainment funding for the Armidale class patrol boats and Arafura class Offshore Patrol Vessels through the transition process.

3.105 In summary, the anticipated delays in the delivery of the evolved Cape class will result in the extension of service of the Armidale class and a reduced in-service period for the evolved Cape class, demonstrating the consequential effect of project schedule delays to ADF capability and the Australian Government's naval shipbuilding strategy. As noted above, Defence's acquisition contract for the six evolved Cape Class patrol boats includes provisions for the payment of liquidated damages.



Grant Hehir
Auditor-General

Canberra ACT
16 December 2021

¹³⁴ Currently the delays to the schedule represent approximately between six and 14 per cent of the overall in-service life of the Cape Class Patrol Boats outlined in the August 2020 Patrol Force Capability Transition Plan.

Appendices

Appendix 1 Department of Defence's response



Australian Government

Department of Defence

PO Box 7900 CANBERRA BC ACT 2610

EC21-004246

Mr Grant Hehir
Auditor-General
PO BOX 707
CANBERRA ACT 2601

Dear ~~Mr Hehir~~ *Dear Grant*

Australian National Audit Office (ANAO) Section 19 Proposed Report – Defence's Procurement of Six Evolved Cape Class Patrol Boats.

Thank you for the opportunity to comment on the Proposed Report for the ANAO performance audit *Defence's Procurement of Six Evolved Cape Class Patrol Boats*.

Defence acknowledges the findings, however does not fully agree with the wording of ANAO's single recommendation and seek your consideration in modifying the recommendation to read:

Recommendation: The Department of Defence identify, assess and manage probity risk at an early stage, when considering and assessing unsolicited proposals.

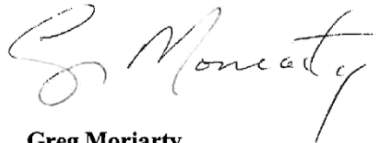
The reasons are described in the Defence comments at Annexes A and C and the Defence Summary Response at Annex D has been framed based on the proposed recommendation. In essence, while the ANAO noted that Defence should have documented the reasons for any departure from the procedural pathway for unsolicited innovative proposals, Defence contends that the procedural pathway referred to is for 'unsolicited *innovative* proposals', of which this proposal was not one. The intent of the referenced pathway is to support Defence managing companies seeking to submit innovation proposals or ideas through the Centre for Defence Industry Capability which hosts the Defence Innovation Portal, the primary gateway to the Defence Innovation Hub and Next Generation Technology Fund.

Attached to this letter are Defence's Proposed Amendments, Editorials and Comments (**Annex A**), Defence's Response to Requests for Information (**Annex B**), Defence's Response to the Proposed Recommendation (**Annex C**) and Defence's Summary Response (**Annex D**). These constitute Defence's formal response to the Section 19 proposed report.

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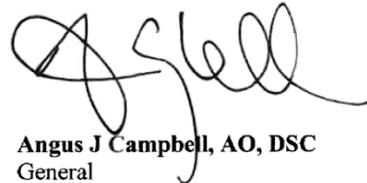
Our point of contact is the ANAO Liaison Officer, Emma Fitzpatrick, who can be contacted by telephone on 02 5108 5813 or via email at: emma.fitzpatrick@defence.gov.au

Yours sincerely



Greg Moriarty
Secretary

26 November 2021



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

30 November 2021

Annexes:

- A) Defence's Proposed Amendments, Editorials and Comments
- B) Defence's Response to Requests for Information
- C) Defence's Response to the Proposed Recommendation
- D) Defence Summary Response

Defence's response to the draft audit report issued under section 19 of the *Auditor-General Act 1997* (Cth) was received on 1 December 2021. Following receipt of the response, the recommendation included in the draft audit report was amended. Part (a) of the recommendation, as drafted, was removed. Defence's response to the revised recommendation is reflected in the body of the report at paragraph 2.87.



Australian Government

Department of Defence

PO Box 7900 CANBERRA BC ACT 2610

Mr Grant Hehir
Auditor-General
PO BOX 707
CANBERRA ACT 2601

Dear Mr ~~Hehir~~ *Grant*,

Australian National Audit Office (ANAO) Section 19 Proposed Report – *Defence's Procurement of Six Evolved Cape Class Patrol Boats*.

Defence acknowledges the revised recommendation and the proposed amendments provided on 7 December 2021. Defence accepts the revised recommendation and acknowledges the incorporation of the Secretary and Chief of the Defence Force advice regarding the department's procurement policy documentation as it relates to the policy requirements for managing unsolicited proposals.

Attached to this letter is the revised Defence Response to the Proposed Recommendation (**Attachment A**). This constitutes Defence's formal response to the Section 19 proposed report.

Our point of contact is the ANAO Liaison Officer, Emma Fitzpatrick, who can be contacted by telephone on 02 5108 5813 or via email at: emma.fitzpatrick@defence.gov.au

Yours sincerely,

Matt Yannopoulos
Associate Secretary

8 December 2021

Attachment:

A) Updated Defence Response to the Proposed Recommendation

Appendix 2 Improvements observed by the ANAO

1. The existence of independent external audit, and the accompanying potential for scrutiny improves performance. Improvements in administrative and management practices usually occur: in anticipation of ANAO audit activity; during an audit engagement; as interim findings are made; and/or after the audit has been completed and formal findings are communicated.
2. The Joint Committee of Public Accounts and Audit has encouraged the ANAO to consider ways in which the ANAO could capture and describe some of these impacts. The ANAO's 2021–22 Corporate Plan states that the ANAO's annual performance statements will provide a narrative that will consider, amongst other matters, analysis of key improvements made by entities during a performance audit process based on information included in tabled performance audit reports.
3. Performance audits involve close engagement between the ANAO and the audited entity as well as other stakeholders involved in the program or activity being audited. Throughout the audit engagement, the ANAO outlines to the entity the preliminary audit findings, conclusions and potential audit recommendations. This ensures that final recommendations are appropriately targeted and encourages entities to take early remedial action on any identified matters during the course of an audit. Remedial actions entities may take during the audit include:
 - strengthening governance arrangements;
 - introducing or revising policies, strategies, guidelines or administrative processes; and
 - initiating reviews or investigations.
4. In this context, the below actions were observed by the ANAO during the course of the audit. It is not clear whether these actions and/or the timing of these actions were planned in response to proposed or actual audit activity. The ANAO has not sought to obtain assurance over the source of these actions or whether they have been appropriately implemented.
 - Austal obtained DISP membership to the level required by the acquisition contract on 31 October 2021.

Appendix 3 Defence patrol boats: summary comparison

Class	Armidale Class	Cape Class/Evolved Cape Class	Arafura Class OPV
Type	Patrol Boat, General (PB)	Patrol Boat, General (PB)	Offshore Patrol Vessel
Pennant	P86	310	N/A
International Callsign	VKDG	VMCF	N/A
Builder	Austal	Austal	Luerssen Australia and Cvmec
Dimensions and displacement			
Displacement	300–330.7 tonnes	306.18 tonnes	1640 tonnes
Length (overall)	56.8 m	58.1 m	80 m
Beam (overall)	9.7 m	10.6 m	13 m
Draught (hull)	2.7 m	3.1 m	4 m
Performance			
Speed	25 knots (top speed)	25 knots (top speed)	20 knots (top speed)
Range	3,000 nautical miles	4000 nautical miles	4000 nautical miles
Crew			
Crew	21	21	40 crew with accommodation for up to 60 personnel
Propulsion			
Machinery	2 MTU 4000 16V diesels; 6,225 hp (4.64 MW); 2 shafts	2 x Caterpillar 3516C diesels; 2 shafts; 1 bow thruster	2 x 4250KW diesel engines
Armament			
Guns	<ul style="list-style-type: none"> One 25 mm Rafael M242 Bushmaster Two 12.7mm machine guns 	Two 12.7mm machine guns	<ul style="list-style-type: none"> 40mm gun 2 x .50 calibre machine guns

Source: Department of Defence information.