



2009

PARLIAMENT OF TASMANIA

**AUDITOR-GENERAL
SPECIAL REPORT No. 81**

Contract management

June 2009

*Presented to both Houses of Parliament in accordance with the provisions of Audit
Act 2008*

By Authority:

Government Printer, Tasmania

© Crown in Right of the State of Tasmania June 2009

Auditor-General's reports are available from the Tasmanian Audit Office, HOBART, although in limited supply. This report and the recent titles shown at the back of this report can be accessed via the Office's home page. For further information please contact:

Tasmanian Audit Office

GPO Box 851

Hobart

TASMANIA 7001

Phone: (03) 6226 0100, Fax (03) 6226 0199

Email: admin@audit.tas.gov.au

Home Page: <http://www.audit.tas.gov.au>

This report is printed on recycled paper.

ISBN 978-0-9804409-9-7



18 June 2009

President
Legislative Council
HOBART

Speaker
House of Assembly
HOBART

Dear Madam President
Dear Mr Speaker

SPECIAL REPORT NO. 81
Contract management

This report has been prepared consequent to examinations conducted under section 26 for submission to Parliament, under the provisions of section 30 of the *Audit Act 2008*.

The report examines the effectiveness of contract management processes for a number of selected contracts.

Yours sincerely

H M Blake
AUDITOR-GENERAL

Contents

Foreword	i
List of acronyms and abbreviations	ii
Independent auditor’s conclusion	2
Responsibility of the Secretaries of the Departments of Economic Development and Tourism, Infrastructure, Energy and Resources and Treasury and Finance.....	2
Auditor-General’s responsibility	2
Auditor-General’s overall conclusion.....	3
Executive summary	6
Background.....	6
Detailed audit conclusions	6
List of recommendations	8
Submissions and comments	10
Introduction.....	10
Submissions and comments received	10
Introduction	14
Audit objective.....	14
Audit scope	14
Audit criteria	15
Audit approach.....	15
Timing.....	16
Resources	16
1 Rail Management and Maintenance Deed	18
1.1 Background	18
1.2 Agreed outcomes.....	19
1.3 Risk management	21
1.4 Monitoring.....	21
1.5 Other governance processes	22
1.6 Conclusion.....	23

2	Hagley and Westbury bypasses.....	26
2.1	Background	26
2.2	Agreed outcomes.....	27
2.3	Risk management	27
2.4	Monitoring.....	28
2.5	Other governance processes	28
2.6	Conclusion.....	29
3	Gas Distribution Development Agreement	32
3.1	Background	32
3.2	Agreed outcomes.....	32
3.3	Risk management	32
3.4	Monitoring.....	33
3.5	Other governance processes	33
3.6	Conclusion.....	34
4	Operations and Maintenance Agreement for the Optic Fibre Backbone.....	36
4.1	Background	36
4.2	Agreed outcomes.....	37
4.3	Risk management	37
4.4	Monitoring.....	38
4.5	Other governance processes	38
4.6	Conclusion.....	39
5	Deed of agreement with The Federal Group	42
5.1	Background	42
5.2	Agreed outcomes.....	42
5.3	Risk management	43
5.4	Monitoring.....	44
5.5	Other governance processes	44
5.6	Conclusion.....	44

6	Common findings.....	46
6.1	Risk management	46
6.2	Monitoring.....	46
6.3	General comments.....	47
7	Recent reports	50
8	Current projects	52

List of figures

Figure 1: Derailments by freight km in 2007.....	20
Figure 2: Development of the optic fibre cable network.....	37

Foreword

The public sector has increasingly been required to or has chosen to enter into contracts, agreements and deeds with the private sector for the purchase of goods or services. The five contracts covered in this audit demonstrate some of the wide range of such procurements, including coverage of ongoing operation and management contracts, major construction projects, and an agreement for exclusive gaming rights. All of the contracts presented unique difficulties for the government departments charged with their management.

Each contract required the provision of a service or function by a private sector provider or the granting of a right. However, the audit was necessarily focused on the performance of the government departments in managing to achieve contracted outcomes rather than that of the private sector. There is therefore a risk that a reader might tend to unfairly attribute deficiencies in contract outcomes solely to weaknesses identified in the contract management of the departments. Our audit conclusions have attempted to avoid unduly making such implications.

The audit findings suggested that contract management in state entities was reasonably effective, but that there is scope for better management of risks, particularly prior to entering into contracts. We also saw a need for improved monitoring of contractors' compliance with the terms of contracts.

H M Blake
Auditor-General
18 June 2009

List of acronyms and abbreviations

Aurora	Aurora Energy Pty Ltd
DED	Department of Economic Development (now Department of Economic Development and Tourism).
DIER	Department of Infrastructure, Energy and Resources
Downer	Downer Connect Pty Ltd
Federal	The Federal Group
GDDA	Gas Distribution Development Agreement
KPI	Key performance indicator
Leighton	Leighton Contractors Pty Ltd
O&M Agreement	Operation and Maintenance Agreement for the Optic Fibre Backbone
PNT	Pacific National Tasmania
Powerco	Powerco Tasmania Pty Ltd
RMMD	Rail Management and Maintenance Deed
RMU	Rail Management Unit
Tas 21	Tas 21 Pty Ltd
Treasury	Department of Treasury and Finance
TSRs	Temporary speed restrictions

Independent auditor's conclusion

Independent auditor's conclusion

This independent conclusion is addressed to the Speaker of the House of Assembly and the President of the Legislative Council. It relates to my performance audit of the effectiveness of contract management in three government departments. My audit was based on the audit objective, audit scope and audit criteria detailed in the Introduction to this Report.

In developing the scope of this audit and completing my work, the three departments concerned provided me with all of the information that I requested. There was no effort by any party to the audit to limit the scope of my work. This Report is a public document and its use is not restricted in any way by me or by any other person or party.

Responsibility of the Secretaries of the Departments of Economic Development and Tourism, Infrastructure, Energy and Resources and Treasury and Finance

These Secretaries were responsible for designing, implementing and maintaining risk management and other internal controls relevant to contract management. This included ensuring there were systems and controls in place to detect fraud or error and to ensure achievement of the objectives specified in each of the five contracts.

Auditor-General's responsibility

In the context of this performance audit, my responsibility was to express a conclusion on whether or not the Departments of Economic Development and Tourism, Infrastructure, Energy and Resources and Treasury and Finance managed the five contracts effectively.

I conducted my audit in accordance with Australian Auditing Standard ASAE 3500 *Performance Engagements*, which required me to comply with relevant ethical requirements relating to audit engagements. I planned and performed the audit to obtain reasonable assurance of whether each of the three departments managed the selected contracts effectively.

My work involved obtaining evidence of the contracts' management based on the objectives and criteria outlined in the Introduction to this Report. The criteria were established by me without influence. The procedures depended on my judgement, based on the criteria and on my assessment of the risks of material misstatement of the information obtained by me as part of this audit.

In making this risk assessment, I considered internal controls, risk management systems and management processes relevant to the management of the selected contracts. For the purpose of expressing this opinion I did not consider the effectiveness of the departments' internal control or risk management processes generally.

I believe that the evidence I have obtained was sufficient and appropriate to provide a basis for my conclusion.

Auditor-General's overall conclusion

Based on the audit criteria and for reasons outlined in the remainder of this Report, it is my conclusion that the Departments of Economic Development and Tourism, Infrastructure, Energy and Resources and Treasury and Finance managed the five contracts reasonably effectively.

However, my work did result in findings leading to four recommendations that government departments should consider when managing contracts.

H M Blake
Auditor-General
Hobart
18 June 2009

Executive summary

Executive summary

Background

The public sector frequently needs or chooses to purchase goods and services from the private sector. Such procurements may relate to the ongoing provision of a service, such as a school bus service. Alternatively, they may involve the construction of major infrastructure projects, such as a road.

Responsibility for managing contracts in Tasmania rests with the agencies procuring the goods or services. For some types of contracts, the agency acquires expertise through repetition, for example, the Department of Energy, Infrastructure and Resources (DIER) with road construction. Many other contracts are ‘one-offs’ posing additional challenges to the managing agency.

While a clearly defined contract is an essential first step, there is an increasing awareness that effective contract management is vital to achieving good contract outcomes. As with project management, contract management requires investment of time and resources and the application of good contract management principles.

Over the past decade, a wealth of material has been developed on what constitutes best practice contract management.¹ Since 2001, The Department of Treasury and Finance (Treasury) has made available guidelines, manuals, checklists and document templates relating to aspects of procurement including contract management.

In this audit, we sought to determine the quality of contract management by government departments, particularly with respect to large-scale and on-going projects.

Detailed audit conclusions

Rail Management and Maintenance Deed

Despite a number of challenges, rail operations had been maintained, albeit on a reduced basis. Expenditure on capital works and maintenance was also approaching the pro-rata levels outlined in the deed. However, the eventual levels of safety and effectiveness had not yet been achieved and there was still considerable uncertainty about the future rail operator.

DIER had been rigorous in its monitoring of expenditure of public funds on capital works and maintenance, whilst maintaining a

¹ *Contract Management: Better Practice Guide* (ANAO, February 2001); *Developing and Managing Contracts: Getting the right outcome, paying the right price* (ANAO, February 2007).

professional relationship with Pacific National Transport (PNT). On the other hand, the lack of risk management, an issues register to document events and systematic monitoring of compliance were of concern.

Hagley and Westbury bypasses

The project, although late, delivered a serviceable highway. Although litigation is not a preferred outcome of the contract management process, in this case effective governance, documentation and risk management placed the state in the best possible position when it did occur.

Gas Distribution Development Agreement

The program achieved its objectives and, with the exception of a lack of risk management and some record keeping deficiencies, the contract was well managed.

Optic fibre operations and management contracts

The 2003 and 2006 O&M Agreements ensured that, while critical developments were taking place, the growing optic fibre network was maintained and operational, if largely unused. The transition from one contract to the other was successful, which then ensured its smooth novation² to Aurora.

Deed of agreement with The Federal Group

Despite limited contract management processes and the approved delay in construction, the construction of the Coles Bay resort was well underway to achieving its objectives.

² 'Novation' is a legal term which refers to the transfer of a deed or contract to another party.

The following table reproduces the recommendations contained in the body of this report.

List of recommendations

Rec No.	Section	We recommend that ...
1	1.3 3.3 5.3	the principal formally recognise major risks and develop management strategies for those risks prior to entering into a contract.
2	1.4 5.4	agencies ensure that all major contracts are monitored with regular updates sought at appropriate intervals.
3	1.5.1	agencies establish a steering committee in addition to a contract management team for contracts with significant risk, materiality and public interest.
4	6.3	agencies make use of contract management expertise and guidelines from entities with relevant experience.

Submissions and comments

Submissions and comments

Introduction

In accordance with section 30(3) of the *Audit Act 2008* a copy of this report, or relevant extracts of this report, were provided to the Departments of Infrastructure, Energy and Resources, Economic Development and Tourism, and Treasury and Finance with an invitation to make submissions or comments. In addition, the ministers of the three agencies were provided with a summary of findings and invited to make submissions or comments.

Similarly, for natural justice purposes, copies were also provided to Pacific National Tasmania, Leighton Contractors Pty Ltd, Downer EDi Engineering, The Federal Group and Powerco Tasmania for comments or submissions.

The comments and submissions provided are not subject to the audit nor the evidentiary standards required to reach an audit conclusion. Responsibility for the accuracy, fairness and balance of those comments rests solely with the agency head.

Submissions and comments received

Private contactors

Pacific National Tasmania:

Chose not to comment.

Leighton Contractors Pty Ltd:

Chose not to comment.

Powerco Tasmania:

‘With regard to the points made on the findings of the project concerning Powerco, on the whole they are balanced and we are comfortable the conclusion reached is appropriate.’

Downer EDi Engineering:

‘Thank you for the opportunity to comment. It is our view that the report accurately describes the background, risk management, outcomes and other matters in relation to the Tasmanian Optical Fibre Cable Network and Downer’s relationship in this project.’

The Federal Group:

The Federal Group advised us of one factual error which we corrected but had no other comment.

Government agencies

Department of Economic Development and Tourism:

I appreciate your fair and positive report in relation to the Gas Distribution Development Agreement (GDDA) and in particular your conclusion that, with the exception of formal risk management and some record keeping deficiencies, the contract was well managed.

I acknowledge the report's statement 'this is not to say that the GDDA and the contract management processes did not address risks' which went on to discuss how certain risks were dealt with. I also acknowledge that, while the risks were managed, there was not a formal written plan setting out in advance perceived risks and management strategies.

I agree with your recommendation that 'the principal formally recognise major risks and management strategies for those risks prior to entering into a contract' and the Department of Economic Development and Tourism (the department) will take on board that recommendation in relation to major procurements in the future.

Department of Infrastructure, Energy and Resources Rail Management and Maintenance Deed

A fundamental point of departure is the purpose of the Rail Management and Maintenance Deed (RMMD). The Outcomes mentioned in 1.2 are a lifted from the RMMD, sometimes out of context and form a significant basis for the audit. DIER has consistently stated that the purpose of the RMMD is to secure rail operations in Tasmania, to manage the proper expenditure of State and Australian Government funds over the life of the RMMD and to ensure that, upon taking over ownership of the rail asset, the Crown was properly indemnified against environmental contamination and other liabilities.

The Deed explicitly states that the safe and efficient operation of the rail network is PNT's responsibility. The expenditure of the funds under the control of the Rail Management Unit are intended to assist in improving safety and effectiveness but only to the extent attributable to track quality and routing. Many other factors beyond the scope of the RMMD can also impact on safety and effectiveness, negatively or positively.

Recommendation 1 is based on the finding that risks were not identified as part of a formal process even though the report acknowledges that both in the RMMD and the operations of the RMU, risk identification and management is evident. Given the fluid circumstances under which the RMMD was negotiated, it is

understandable that the risks might not have been formally recorded at the time.

Audit's view of the level of senior management involvement was a significant point of discussion throughout the audit. Despite being asked on a number of occasions, Audit staff could not point to any documentary evidence of a lack of engagement, involvement or support provided by senior management in the management of the RMMD. The sole point of contention seemed to be the lack of formal written advice of decisions provided verbally from senior management to RMU staff.

In respect of Recommendation 1, DIER ensured that the major risks of a continuing rail operation, the proper expenditure of funds and indemnity against liabilities associated with ownership of the rail network were central to the RMMD. However, the Department supports the recommendation as sound management practice. DIER supports Recommendation 2. DIER supports Recommendation 3 as a general statement but considers the management structure implemented to manage the RMMD has delivered a successfully managed Deed at just over two years into a ten year agreement.

Hagley and Westbury bypasses

This chapter demonstrates that significant contract management skills were applied by DIER in the delivery of the Hagley and Westbury bypasses. While litigation may not be a preferred outcome it is always possible in the delivery of such large and complex contracts. DIER managed the contract with this as one of the many potential risks. As the chapter notes, significant legal issues relevant to DIER and other road authorities were settled through this litigation in favour of the road authorities.

Department of Treasury and Finance

Treasury notes the comments and findings of the Auditor-General in respect to monitoring of compliance under the Federal Hotels Deed. While Treasury believes that the circumstances of the project construction commitments in the Deed are fairly rare, Treasury will ensure that the Auditor-General's conclusions are taken into account in establishing an appropriate monitoring regime should similar circumstances arise again in the future.

Treasury agrees that, with construction of the project having commenced, and the Government having advised Federal Hotels of its reluctance to grant further extensions, more formal active compliance arrangements are now appropriate.

Ministers

No submissions or comments were received.

Introduction

Introduction

Background

The public sector frequently needs or chooses to purchase goods and services from the private sector. Such procurements may relate to the ongoing provision of a service, such as a school bus service. Alternatively, they may involve the construction of major infrastructure projects, such as a road.

Responsibility for managing contracts in Tasmania rests with the agencies procuring the goods or services. For some types of contracts, the agency acquires expertise through repetition, for example, the Department of Energy, Infrastructure and Resources (DIER) with road construction. Many other contracts are 'one-offs' posing additional challenges to the managing agency.

While a clearly defined contract is an essential first step, there is an increasing awareness that effective contract management is essential to achieving good contract outcomes. As with project management, contract management requires investment of time and resources and application of good contract management principles.

Over the past decade, a wealth of materials has been developed on what constitutes best practice contract management.³ Since 2001, The Department of Treasury and Finance (Treasury) has made available guidelines, manuals, checklists and document templates relating to aspects of procurement including contract management.

In this audit, we sought to determine the quality of contract management by government departments, particularly with respect to large-scale and on-going projects.

Audit objective

The primary audit objective was to determine the effectiveness of contract management in government departments.

Audit scope

The scope of the audit included:

- contracts entered into by government departments with private sector organisations
- contracts entered into between 1999 and 2008
- large-scale and/or ongoing contracts.

³ *Contract Management: Better Practice Guide* (ANAO, February 2001); *Developing and Managing Contracts: Getting the right outcome, paying the right price* (ANAO, February 2007)

Based on these parameters we selected the following five contracts:

Name of contract	Provider	Date commenced	Responsible agency
Rail Management and Maintenance Deed	Pacific National Tasmania	2007	DIER
Upgrading of the Bass Highway, Westbury and Hagley Bypasses	Leighton Contractors Pty Ltd	1999	DIER
Gas Distribution Development Agreement (Stage 2A: Restated)	Powerco Tasmania Pty Ltd	2003–04	DED
Operations and Maintenance Agreement for the Optic Fibre Backbone	Downer Connect Pty Ltd	2003 and 2006	Treasury
Deed of Agreement	The Federal Group	2003	Treasury

Audit criteria

The following audit criteria were used to form an audit opinion about the audit objective:

- Were the agreed outcomes achieved?
- Did risk management underpin the contract management approach?
- Was performance reporting and monitoring comprehensive and consistent?
- Was record keeping and documentation thorough?
- Was senior management involved in management of the contract and was there an adequate governance structure?
- Were relationships between parties constructive and professional?

Audit approach

To conduct the audit we:

- made a comparison of the agreed outcomes as detailed in the contract with the actual outcomes on completion

- assessed the effectiveness of contract management processes used during the course of the contract
- interviewed agency contract managers and team members
- reviewed relevant contract documentation.

Timing

Planning for this performance audit began in August 2008. Fieldwork was completed in April 2009 and the report was finalised in May 2009.

Resources

The total cost of the audit excluding production costs was \$146 300.

1 Rail Management and Maintenance Deed

1 Rail Management and Maintenance Deed

1.1 Background

The Rail Management and Maintenance Deed (RMMD or ‘the deed’), between the government and Pacific National Tasmania (PNT), came into operation on 1 January 2007. The deed was the result of dramatic events 15 months earlier when PNT had sought government funding to secure the ongoing operation of the Tasmanian rail network.

PNT had acquired the rail network in 2004 from the former operator, Australian Transport Network, which in turn had acquired the service from the Australian Government in 1997. When PNT took over the network, it inherited an infrastructure asset which was widely regarded as needing substantial maintenance and capital improvement.

With substantial freight services — including the transport of coal, cement, paper and containerised cargo — at risk, the Australian Government responded to PNT’s 2005 ultimatum with a commitment of \$78 million for capital works to improve track quality. In turn the state government agreed to take back ownership of the network and as asset owner, committed \$44 million over 10 years for administration and much-needed maintenance work. The RMMD formalised PNT’s responsibilities under the new arrangement. These included \$38 million to upgrade its rolling stock over a 10-year period, continuance of its rail operation activities, including intermodal rail service for 10 years, maintenance and train control.

While the RMMD was being negotiated, consideration was given to what would be the most appropriate governance structure for the new arrangements. A new unit, the Rail Management Unit (RMU) was established within the Department of Infrastructure, Energy and Resources (DIER) to manage the deed following the consideration of a number of alternative governance models.

Our purpose in this investigation, as with others in this Report, was solely to determine how well the particular government department managed the relevant contract. Since our mandate does not include the performance of private contractors, by necessity the following sections relate only to DIER. In addition, our findings only relate to events in the first two years of the 10-year contract.

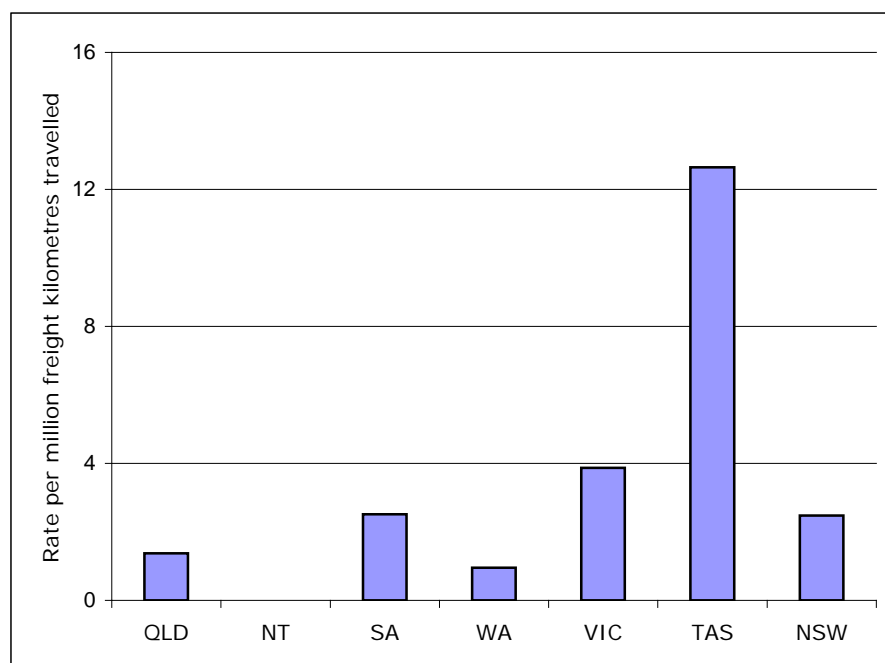
1.2 *Agreed outcomes*

Three major outcomes specified in the deed are a safe, effective rail network and the expenditure of funds for maintenance, capital works and rolling stock upgrade.

1.2.1 *A safe, effective rail network*

While the network has continued to operate, it has not as yet achieved the eventual levels of safety and effectiveness envisaged by the deed. Issues of concern include:

- **Extensive use of speed restrictions**
As the accredited rail operator, PNT chose to make extensive use of Temporary Speed Restrictions (TSRs) across the network as a safety management strategy. While TSRs are a standard safety measure, their widespread use can also have an impact on productivity. In 2008, the use of TSRs peaked in March when they were in place on 27% of the network.
- **Reduced annual freighted tonnage**
From 2002/2003 to 2007/2008, the annual tonnage carried on the network reduced by 16%.
- **Loss of an important contract**
The decision by Cornwall Coal to change to road freight in mid 2008 was expected to further reduce annual tonnages.
- **Frequent derailments**
Derailments may be caused by a variety of factors, including track quality, human error and rolling stock problems, of which track quality is the only factor subject to the deed. Figure 1 shows derailments by freight kilometre for Tasmania and other jurisdictions.

Figure 1: Derailments by freight km in 2007

This figure shows that for 2007, Tasmania's rate of derailment per freight kilometre was, on average, seven times higher than other states.⁴

1.2.2 Expenditure of funds

After an initial delay, the expenditure of state and federal funds had gathered momentum by the end of April 2009. Capital works contracts valued at \$26 million had been allocated and further tenders were being called. There was however, a short fall in expenditure on PNT's rolling stock upgrades.

1.2.3 Current situation

The task of bringing the Tasmanian rail network — which still essentially follows the original 19th century routes — into the 21st century continues to be a challenge.

In November 2008, PNT announced that its sale negotiations had been unsuccessful and that it was leaving the state by the end of the year. At the time of writing, the government was in negotiations with PNT as to the future of both network operation and rolling stock.

⁴ This Australian Transport Safety Bureau data is used in order to make comparison with other states. This data includes derailments on all lines, including those not owned by state governments.

1.3 *Risk management*

No formal risk assessment exercise was undertaken prior to the commencement of the deed and no risk management was undertaken once the deed was in operation. The explanation provided was the short timeframe between the announcement of the Rail Rescue Package and the commencement of the RMMD.

Some of the major risks that we would have expected to be formally recognised include:

- possible loss of significant freight contracts
- operator pulling out of the state
- derailments
- difficulties in establishing and implementing a maintenance program
- difficulties in establishing and implementing a capital works program.

Despite the lack of a formal process, the RMU was aware of risks to the success of the deed and put into place a number of control measures such as the Invoice Verification System and the commissioning of a third party to undertake independent track assessments. It also commissioned an independent audit of the rolling stock upgrade program.

Recommendation 1

We recommend that the principal formally recognise major risks and develop management strategies for those risks prior to entering into a contract.

1.4 *Monitoring*

We found no evidence that a monitoring system had been developed to ensure compliance with all the reporting and performance requirements of the deed. A systematic approach to monitoring performance and compliance is an essential aspect of effective contract management.

We did however find that the RMU took considerable care to develop a rigorous system to ensure that funds were only expended in accordance with the deed. Under the Invoice Verification System, payment of monthly invoices was dependent on verification by inspection that the maintenance work had been completed to the standard required. The RMU was assiduous in its application of the system, to the extent that by October 2008, unpaid claims which

could not be substantiated under the Invoice Verification System, amounted to \$500,000. PNT and DIER subsequently entered into a mediation process in order to reach agreement on these claims.

The RMMD contained a number of formal reporting requirements on PNT, including reports on condition assessments, planned and completed maintenance, and planned and completed capital works. The RMU was diligent in attempting to achieve compliance with these requirements, but with mixed success.

Reporting against KPIs was also problematic. While a list of KPIs was included as an attachment to the deed, the RMU itself believed that these were inadequate. It is not surprising, therefore, that no reporting against these KPIs took place.

Recommendation 2

We recommend that agencies should ensure that all major contracts are systematically monitored with regular updates sought at appropriate intervals.

1.5 *Other governance processes*

1.5.1 *Governance*

The RMU had responsibility for the day-to-day operation of the deed. The unit was established to manage the deed and by necessity the unit developed considerable rail expertise.

Senior management involvement in the management of the deed took the form of:

- fortnightly meetings between the manager of the RMU and the relevant DIER Deputy Secretary
- weekly written reports from the RMU on current issues
- briefing papers from the RMU to the Deputy Secretary and Secretary
- discussions and correspondence with parent company Pacific National on the PNT sale process and the dispute mediation.

A significant issue for us was whether or not senior departmental management was actively involved with respect to a number of possible instances of non-compliance by PNT, referred by the RMU.

We were unable to find documentation of internal decision-making regarding these issues but we did find evidence of departmental responses.

In respect to the lack of documentation of decision-making processes we advocate a more formal process, such as a steering committee, with oversight of the contractor's performance.

Recommendation 3

We recommend that agencies establish a steering committee in addition to a contract management team for contracts with significant risk, materiality and public interest.

1.5.2 Record keeping

Record keeping for this contract was adequate.

There did appear to have been a lack of documentation relating to the events of 2007 and 2008. This was partly a result of the lack of any formal risk assessment or risk monitoring. Nor was an issues register maintained, which would have identified and monitored non-compliance issues as they arose. As it was, documentation of events is largely contained in correspondence between the parties.

1.5.3 Relationships

The relations between the government and PNT during the course of the RMMD need to be seen in the context of events preceding the deed.

The state government had been placed in a difficult position firstly by PNT's ultimatum in 2005 and then by the Australian Government's unilateral funding announcement which was dependent on a commitment of funds from the state government. In addition, there were severe time constraints between the finalisation of negotiations with PNT in 2006 and the commencement of the deed in January 2007.

Evidence from both formal correspondence and emails between the parties reveal that DIER was consistently firm but courteous, while its senior management consciously adopted a conciliatory approach in order to maintain a good working relationship. A conciliatory approach was also adopted during the mediation process.

1.6 Conclusion

Despite a number of challenges, rail operations had been maintained, albeit on a reduced basis. Expenditure on capital works and maintenance was also approaching the pro-rata levels outlined in the deed. However, the eventual levels of safety and effectiveness had not yet been achieved and there was still considerable uncertainty about the future rail operator.

DIER had been rigorous in its monitoring of expenditure of public funds on capital works and maintenance, whilst maintaining a professional relationship with PNT. On the other hand, the lack of risk management, of an issues register to document events and systematic monitoring of compliance were of concern.

2 Hagley and Westbury bypasses

2 Hagley and Westbury bypasses

2.1 *Background*

In 1998, Department of Infrastructure, Energy and Resources (DIER) appointed Leighton Contractors Pty Ltd (Leighton) to design, construct and maintain 13 kilometres of new highway to bypass the northern towns of Hagley and Westbury. The project was the final section of the highway between Launceston and Deloraine to be upgraded to national highway standard and was funded by the Australian Government.

The scale of the road-building project was unprecedented in Tasmania for its timeframe, cost and complexity. The \$24.6 million contract specified completion of the design and construction phases within 21 months from commencement. Upon completion of the construction phase, the contractor was to maintain the road for a further 10 years — ending 2011. Designing and constructing the road involved additional contractors including:

- contract manager — contracted by DIER
- designer — contracted by Leighton
- design verifier — contracted by Leighton.

The contract paid particular attention to minimising the environmental impact of the new highway. Part of the Hagley bypass required a realignment of the highway to pass through the sensitive area of cultural landscape that included Hagley Mill and nearby Hagley House — listed on the register of the National Estate in 1996. The environmental documents included in the contract required the construction of this section of road to be below ground (in-cut). Leighton submitted design concept drawings in its tender documentation showing the road as being in-cut as it passed Hagley House. Leighton was awarded the contract and a deed signed specifying the terms of the contract.

Subsequently, Leighton submitted detailed designs that clearly showed the road to be over a metre above ground level, rather than in-cut, as required by the deed. Despite this, the design verifier found the design to be compliant.

Construction in the area of Hagley House commenced in the first half of 2000. In May 2000 DIER was notified by a concerned resident that it appeared that the road was being built above ground in the Hagley House and Mill precinct rather than below ground as had been documented in the original plans.

DIER directed Leighton to restore the road to below ground level. Leighton claimed that this constituted a variation to the contract and

argued that DIER should grant an extension of time and pay associated costs. The resulting dispute proved difficult to resolve and despite attempts at mediation resulted in Tasmania's longest running civil court case.

The state eventually won the case. The Supreme Court found that the design was not in accordance with the deed and was not properly verified. A separate issue relating to liquidated damages continued on to appeal, which again the state won.

2.2 *Agreed outcomes*

The contract delivered a serviceable highway that carries over 7000 vehicles per day, bypassing the townships of Hagley and Westbury, however:

- The project was completed 229 days after the contracted completion date.
- Additional costs, based on agreed change orders of \$400 000 or 2% of total contract were incurred.

Although DIER received \$1.8 million in liquidated damages as compensation for the late completion, litigation is not the preferred method to achieve an outcome, because of potential adverse impacts on relationships and redirection of internal resources. That said, we acknowledge that:

- Considerable efforts were made to resolve the contentious matters, including formal mediation sessions, before litigation was initiated.
- The Court's decision did resolve a matter of national significance: that a state has the right to apply liquidated damages, even though the Australian Government provided the funding.

2.3 *Risk management*

For this criterion we were looking for identification of major risks inherent in a contract and control measures or mitigation strategies to address those risks.

In November 1997 prior to the tendering process an external management consultant was engaged to run a workshop to identify risks. The risks identified included the major risks we had expected, including:

- detailed designs not being in accordance with project specifications

- construction not being in accordance with the detailed design
- cost overruns
- safety risks
- late completion.

The process also involved development of the Review of Risk Assessment in February 1998, which included risk strategies and determination of responsibilities and timing.

We were satisfied that risks were assigned to the various management groups and implemented in the tendering processes and requirements of the project deed.

2.4 *Monitoring*

Monitoring was assigned to the external contract manager. We found that:

- thorough monthly reports were prepared
- reports dealt with all of the contract requirements and deliverables that we selected for testing
- performance information including milestones was comprehensive and meaningful
- there was persuasive evidence that the reports had been reviewed and action points identified by DIER.

2.5 *Other governance processes*

2.5.1 *Governance structure*

Governance processes consisted of:

- fortnightly site meetings
- monthly Risk Management Group meetings
- monthly Project Control Group meetings
- monthly Executive Management Group meetings.

We sighted minutes of meetings, which included evidence of review and action taken on issues identified in reports. We were satisfied that there was adequate oversight of the operation of the contract at appropriate levels of governance.

2.5.2 *Record keeping*

The design, construction and maintenance contract for the Hagley and Westbury bypasses generated some 400 000 documents.

Documents required for the audit were readily available. In particular, we were able to access:

- records of meetings
- contract management plans and procedures
- details of contract variations.

2.5.3 Relationships

The relationships between the parties were complex and at times contentious, with a civil court case resulting from the design and construction phase of the project. Examination of minutes also indicated that there was debate over various matters including claims for variation of contract.

Despite this we found that:

- roles and responsibilities were clearly defined
- scheduled and unscheduled meetings between the parties were held at various levels including executive and project management levels. The minutes indicated that the meetings were professionally conducted
- many attempts were made to resolve contentious issues including formal mediation sessions.

2.6 Conclusion

The project, although late, delivered a serviceable highway. Although litigation is not a preferred outcome from the contract management process, in this case effective governance, documentation and risk management placed the state in the best possible position when it did occur.

3 Gas Distribution Development Agreement

3 Gas Distribution Development Agreement

3.1 *Background*

The state government, represented by the Department of Economic Development (DED), and Powerco Tasmania Pty Ltd (Powerco) signed the Gas Distribution Development Agreement (GDDA) on 27 September 2004. The agreement provided for state financial assistance of \$46.4 million for the development of a gas distribution network to an estimated 38 700 domestic, small commercial and industrial customers. Powerco would own the infrastructure, servicing 11 specified zones in Hobart, Launceston, Devonport and Burnie.

The objective of the agreement was to make available an alternative, competitively priced energy source by facilitating the introduction of natural gas to Tasmania on a commercial basis. Powerco commenced construction in December 2004.

DED used a private contractor — a professional consulting engineering firm with substantial gas industry experience — to provide monitoring and reporting of Powerco's progress during the construction of the gas network. The contractor used geographic information technology to map the reticulation process and confirmed the achievement of the milestones.

In April 2007 Powerco claimed project completion, since gas had been provided to more than the stipulated number of premises (some 43 000 actually passed compared to 38 700 required). However, the network had not been completed across all the specified zones and a dispute arose as to whether or not Powerco was obligated to do so. The dispute was settled when Powerco agreed to extend its Hobart and Burnie networks to include additional non-residential customers.

3.2 *Agreed outcomes*

Powerco achieved all the five milestones for the project in accordance with the GDDA. As noted, a dispute with respect to final completion of Powerco's obligations in the GDDA was resolved to the satisfaction of both parties.

3.3 *Risk management*

There was no specific risk management plan for the project. Some of the major risks that we would have expected to be formally recognised include:

- contractor fails to complete project

- safety risks
- issues with local councils
- late completion.

We found no evidence that DED had formally identified related matters as risks or developed risk management strategies.

This is not to say that the GDDA and the contract management processes applied by DED did not address risks. For example, DED instigated amendments to applicable acts and Municipal Standards to mitigate against the risk of potential issues with local councils. The Department of Justice's Office of Gas Safety provided assurance for the safety of the network as Powerco installed the pipes. We also noted that DED appointed the private contractor, mentioned earlier, to verify Powerco's compliance and to monitor progress against milestones.

As stated in Recommendation 1:

We recommend that the principal formally recognise major risks and develop management strategies for those risks prior to entering into a contract.

3.4 *Monitoring*

DED made payments to Powerco on successful completion of milestones, as monitored by DED's private contractor.

We verified that the private contractor provided monthly progress reports. The reports were comprehensive and provided an analysis of progress, including detailed information and charts. As noted, other than the dispute over final completion, Powerco met all the milestones in accordance with the contract.

3.5 *Other governance processes*

3.5.1 *Governance structure*

A contract management team was established. The team relied significantly on the private contractor to monitor progress. We were satisfied that there was adequate reporting to and oversight from senior management.

3.5.2 *Record keeping*

We were able to access:

- correspondence between the parties
- regular progress reports from the private contractor

- minutes of meetings related to the dispute.

However, we found no evidence of a contract management plan or clearly specified procedures. We were also advised that routine project control group meetings were not formally minuted, as required under the terms of the contract.

3.5.3 Relationships

The GDDA defines roles and responsibilities, including appointment of responsible officers from the two parties and a dispute resolution process. It also provides for the establishment of a Project Review Group consisting of representatives of the state and the distributor, Powerco. The Project Review Group had informal and regular (quarterly) meetings.

As noted in Section 3.1, a dispute arose between the parties as to whether all the deliverables had been met. All parties rigorously followed the dispute resolution process in the GDDA, which included:

- serving of documents
- meetings at management and CEO level
- request for variation to the contract
- Crown Law advice.

Eventually, a compromise was reached. From our examination of correspondence, we found the relationships between the parties were both constructive and professional.

3.6 Conclusion

The program achieved its objectives and, with the exception of a lack of formal risk management and some record keeping deficiencies, the contract was well managed.

4 Operations and Maintenance Agreement for the Optic Fibre Backbone

4 Operations and Maintenance Agreement for the Optic Fibre Backbone

4.1 *Background*

In 2001, an optic fibre backbone was laid by private operator Tas 21 Pty Ltd (Tas 21) as the first step in providing Tasmania with an additional high-speed broadband service. Tas 21 was a subsidiary of Downer Connect Pty Ltd (Downer), created for the purpose of establishing the Tasmanian optic fibre backbone. The optic fibre cable was laid alongside Duke Energy's natural gas pipeline.

Initially, the Operations and Maintenance Agreement for the Optic Fibre Backbone (O&M Agreement) was an internal maintenance agreement between Tas 21 and Downer which also ensured telemetry monitoring services for Duke Energy's gas pipeline.

In 2003 the government acquired the optic fibre backbone from Tas 21 for \$23 million with the intention of completing the necessary extensions to make it fully operational for a commercial operator.⁵ By acquiring the backbone, the government became the principal in the O&M agreement with Downer.

However, since the O&M Agreement was essentially an internal company contract, it was necessary to modify the contract so that it would be acceptable to a future commercial operator. After extensive negotiations with Downer over an 18-month period, a new O&M Agreement was signed between the government and Downer on 23 October 2006.

The entire optic fibre network — which now includes the original backbone and extensions into the cities — has remained inactive since it was laid, apart from the monitoring services which are essential safety requirements to assess gas pressure. Delays to the commercialisation of the network have included difficulties with commonwealth funding, change of ownership of Basslink and a drawn out tender process for the commercial operator.

The government continued to be the principal to the O&M Agreement until Aurora was chosen as the successful operator and the agreement was novated⁶ to Aurora on 10 November 2008.

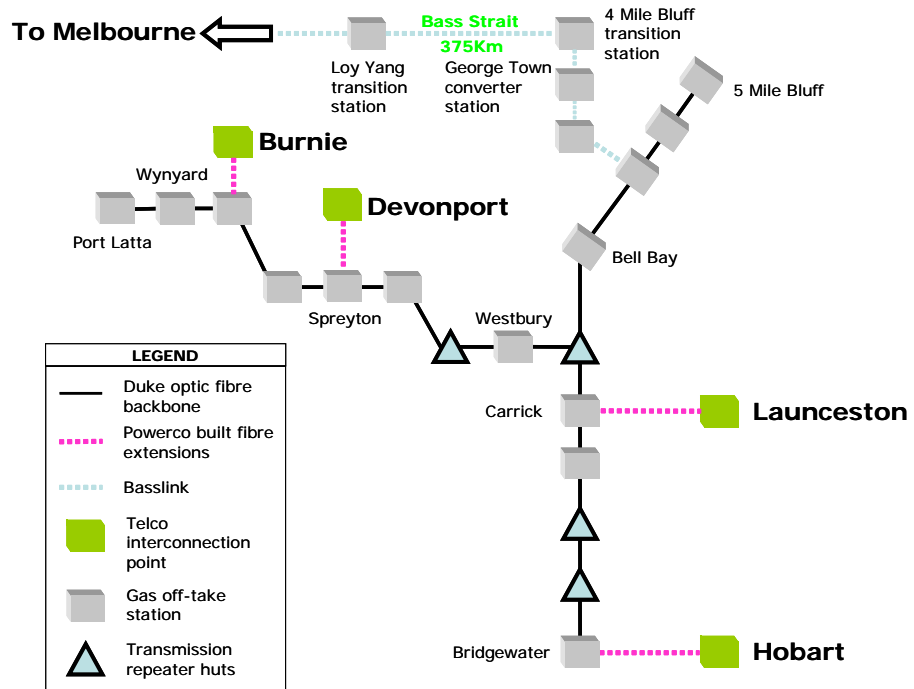
⁵ Optic fibre cable connecting Tasmania to the mainland had been laid in 2000 with the Basslink undersea electricity cable. The Basslink optic fibre cable is connected to the Tasmanian optic fibre network, but is owned and operated separately and is therefore outside the scope of this audit.

⁶ 'Novated' is a legal term referring to the transfer of a deed or contract to another party.

Our audit focused on the period between the government taking ownership of the network from Tas 21 in 2003, to when it novated the contract to Aurora in late 2008.

The map below illustrates the sequential development of the optic fibre network.

Figure 2: Development of the optic fibre cable network



4.2 Agreed outcomes

The intention of both the 2003 and 2006 O&M Agreements was to maintain the network and guarantee the provision of monitoring services. Initially this was just to Duke Energy but later included the Powerco gas pipelines as the network was extended. The fact that there were no interruptions to this service during the five-year period the two contracts operated indicated that this outcome was achieved.

An additional intention of the 2006 contract was to ensure a smooth transition to a commercial operator. The original contract was redrafted to ensure it was commercially viable and could be novated intact to Aurora. This has now occurred.

4.3 Risk management

Risk management underpinned the approach to the commercialisation of the network. The O&M Agreement was a small part of the complex Telecommunications Infrastructure Project which was managed by Treasury. The project as a whole adopted the government’s project management guidelines which had

clear requirements for the development of a risk management plan and a risk register. This register formed a part of the monthly project committee meetings.

Important aspects of the O&M Agreement were included in the project risk register. In addition, the government sought legal advice soon after acquiring the O&M Agreement as to the risk associated with the original deed and the need to change it into a more commercially viable document.

4.4 *Monitoring*

During this time, Treasury took the view that the best and only necessary indication of the quality of Downer's performance was whether essential monitoring services were being provided. These monitoring services were consistently maintained, except for unavoidable disruptions while the network was being extended.

Downer was required to submit monthly performance reports for both contracts relating to maintenance activities and the provision of monitoring services. Under the first contract, these included invoices for work completed.

Reports under the second contract did not contain invoices since fees were fixed. However, these reports were more detailed since the revised contract also included construction specifications and reporting requirements for extensions to complete the network.

4.5 *Other governance processes*

4.5.1 *Governance structure*

The Telecommunications Infrastructure Project Steering Committee was a whole-of-government committee established in 2002 to guide the completion of the network and manage the tender process to identify a commercial operator. The committee chair was a Deputy Secretary of Treasury and members included representatives from the Department of Education and the Department of Premier and Cabinet. The management of the O&M Agreement came under its oversight.

The director of the project, who was also the contract manager for the agreement and a Treasury officer, provided the committee with detailed monthly reports on the progress of the entire project and when appropriate, developments with the O&M Agreements.

We found evidence of the direct involvement of the committee chair at critical moments in the development of the second contract and that the O&M Agreement was fully incorporated into the management processes of the overall project.

4.5.2 Record keeping

The documentation for the Telecommunications Infrastructure Project as a whole was detailed and thorough. Despite some delays in locating some related documents, the documentation for the two O&M Agreements was adequate.

4.5.3 Relationships

At the heart of the relationship between Treasury and Downer, were the negotiations which resulted in the successful transition from the first to the second contract. The new contract included far more rigorous change control mechanisms and reporting requirements on Downer and in a number of aspects, was not as commercially appealing to the contractor. However, through negotiation, Treasury produced a document that was later successfully novated to the commercial operator and also ensured the contractor a stake in the Tasmanian telecommunications industry.

There were no disputes during the five-year period in which the government was principal to the contract.

4.6 Conclusion

The 2003 and 2006 O&M Agreements ensured that, while critical developments were taking place, the growing optic fibre network was maintained and operational, if largely unused. The transition from one contract to the other was successful, which then ensured its smooth novation to Aurora.

5 Deed of agreement with The Federal Group

5 Deed of agreement with The Federal Group

5.1 *Background*

In March 2003 the government signed a deed with an initial term of 15 years with The Federal Group (Federal). The initial term was followed by a succession of discrete five-year terms subject to annual review by the responsible Minister. Federal owns substantial tourist assets that include the only two licensed casinos in Tasmania. The agreement granted Federal exclusive rights to:

- conduct casino operations
- operate gaming machines
- conduct games of Keno.

Federal on its part agreed to a number of undertakings, including:

- application of Federal's best endeavours to continue to improve player protection measures and to support the government's own initiatives
- development of a new premium standard tourist resort near Coles Bay (or another site within Tasmania) at a cost of at least \$25 million with actual construction starting by October 2003 with the project completed by early 2005
- use of Tasmanian contractors and labour
- use of Tasmanian materials where possible and commercially feasible.

Similar conditions were incorporated in a previous 1993 agreement, whereupon receiving exclusive rights Federal agreed to spend up to \$25 million in upgrading its two casinos.

The Department of Treasury and Finance (Treasury) was given the responsibility to manage the deed.

5.2 *Agreed outcomes*

The deed of agreement with Federal granted it a number of exclusive rights but also a number of undertakings (refer Section 5.1).

We were satisfied that Federal was working with the government to improve player protection measures and harm minimisation initiatives, including:

- winnings not to exceed \$500 in cash, with the rest paid by cheque
- procedures put in place to ensure the gaming machine cap was not breached
- consultations were underway with Treasury on implementing some of the Social and Economic Impact Study recommendations.⁷

We were also satisfied that Federal was proceeding with the Coles Bay development in accordance with the deed of agreement. We found that:

- construction was expected to be completed near the latter part of 2009
- where commercially viable, Tasmanian materials and labour were being used
- the development was to focus on providing premium standard accommodation
- the final cost for constructing the development would exceed \$25 million.

However, whilst the completion date for the Coles Bay development was originally early 2005 it is now late 2009 after Federal was granted three extensions by the government.

The development included an upgrade to the area's fresh water infrastructure which resulted in planning approval taking longer than anticipated.

5.3 *Risk management*

This agreement was dissimilar from any of the other contracts discussed in this Report because the government itself was not funding or providing incentive payments to any contractors. Instead, it granted exclusive commercial rights to Federal that were linked to Federal providing additional capital investment in Tasmania.

Focusing on the Coles Bay development from a risk management perspective, the government's major risk was that Federal might not proceed with the development or only proceed with a scaled-back investment. We found no risk management processes in place to mitigate this risk. As stated in Recommendation 1:

⁷ South Australian Centre for Economic Studies, *Social and Economic Impact Study into Gambling in Tasmania*, was commissioned by Department of Treasury and Finance, Tasmania, June 2008.

We recommend that the principal formally recognise major risks and develop management strategies for those risks prior to entering into a contract.

5.4 *Monitoring*

We found no evidence that progress reports on the Coles Bay development had been requested, scheduled or recorded. We also noted that no milestones were set other than the commencement date for construction in October 2003 and the completion date of early 2005. The only updates obtained were in the form of requests for extension with no indication that these were in response to Treasury inquiries. As stated in Recommendation 2:

We recommend that agencies ensure that all major contracts are monitored with regular updates sought at appropriate intervals.

5.5 *Other governance processes*

5.5.1 *Governance structure*

Normally, an agency would appoint a contract management team or individual to oversee major contracts supported by active participation from senior management. No such team was established, however Treasury did have one of its Deputy Secretaries monitor the project. In our view the limited deliverables in the contract justified the streamlined governance approach.

5.5.2 *Record keeping*

Few records have been kept for this project because there was limited government involvement in overseeing the implementation of the contract. Treasury had also chosen a low-key approach in monitoring the project.

5.5.3 *Relationships*

Despite Treasury's limited contact with Federal there was no evidence of disputes and we were satisfied that a constructive and professional relationship existed.

5.6 *Conclusion*

Despite limited contract management processes and the approved delay in construction, the construction of the Coles Bay resort was well underway to achieving its objectives.

6 Common findings

6 Common findings

The following contract management deficiencies were noted in more than one of the contracts reviewed:

- lack of risk management
- lack of systematic monitoring.

6.1 *Risk management*

The key elements that we were looking for in relation to risk management were identification of major risks and development of risk management strategies (control measures or mitigation strategies). Some of the elements of risk management that we considered important included:

- that risk analysis was performed prior to entering into the contract
- that responsibility for risk management resided with the contracting agency and not transferred to a third party such as an external contract manager
- recognition of non-financial risks, such as risk to reputation
- use of a risk register to record risks and corresponding control measures or mitigation strategies
- a process to ensure regular review of risks, control measures and mitigation strategies. In some cases some of those control measures and mitigation strategies may be embedded as requirements in the contract, in which case review of risk will coincide with monitoring of compliance with the terms of the contract.

We found that formal risk management processes had not been implemented to our satisfaction in three of the five contracts reviewed. Deficiencies included lack of a formal upfront process, lack of a risk register and failure to regularly review the status of risks and risk strategies.

6.2 *Monitoring*

Our view was that monitoring was fundamental to ensuring that outcomes were achieved and was essential regardless of the scale of the contract. It is only through systematic monitoring that principals can ensure that the contractor complies with the requirements of the contract.

Some of the elements of monitoring that we considered important included:

- use of a systematic approach
- listing significant contract requirements, milestones and deliverables in a monitoring schedule
- determining the required frequency of monitoring
- identifying who has responsibility for monitoring each requirement or deliverable. This might be an external party with expertise in the matters subject to the contract.

We found deficiencies with monitoring in two of the five contracts reviewed. Problems included a failure to identify contract requirements and the lack of a monitoring system (for example, checklists or predetermined milestones).

6.3 *General comments*

A general observation was that contract management is an important and potentially complex task, regardless of the size of the project. In our view it is beneficial for inexperienced contracting agencies to make use of expertise and contract management guidelines from entities with relevant experience. Examples of guidance available include:

- contract management material from the Department of Treasury and Finance’s website *Buying for Government*, and the risk management section of the state government’s project management guidelines
- the Australian National Audit Office two best practice guides on contract management⁸
- agencies’ own contract management manuals. The Department of Infrastructure, Energy and Resources has a very extensive manual for managing road construction contracts.

Recommendation 4

We recommend that agencies make use of contract management expertise and guidelines from entities with relevant experience.

⁸ *Contract Management: Better Practice Guide* (ANAO, February 2001); *Developing and Managing Contracts: Getting the right outcome, paying the right price* (ANAO, February 2007).

This page left blank intentionally

7 Recent reports

7 Recent reports

Year	Special Report No.	Title
2005	54	Compliance audits
2005	55	Gun control in Tasmania
2005	56	TT-Line: Governance review
2005	57	Public housing: Meeting the need?
2005	58	FBT Payment of accounts Asset management: Bridges
2006	59	Delegations in government agencies Local government delegations Overseas Travel
2006	60	Building security Contracts appointing Global Value Management
2006	61	Elective surgery in public hospitals
2006	62	Training and development
2006	63	Environmental management and pollution control act by local government
2006	64	Implementation of aspects of the <i>Building Act 2000</i>
2007	65	Management of an award breach Selected allowances and nurses' overtime
2007	66	Follow-up audits
2007	67	Corporate credit cards
2007	68	Risdon Prison: Business case
2007	69	Public building security
2007	70	Procurement in government departments Payment of accounts by government departments
2007	71	Property in police possession Control of assets: Portable and attractive items
2008	72	Public sector performance information
2008	73	Timeliness in the Magistrates Court
2008	74	Follow up of performance audits April – October 2005
2008	75	Executive termination payments
2008	76	Complaint handling in local government
2008	77	Food safety: safe as eggs?
2009	78	Management of threatened species
2009	79	Follow up of performance audits: April – August 2006
2009	80	Hydro hedges

8 Current projects

8 Current projects

Performance and compliance audits that the Auditor-General is currently conducting:

Profitability, and economic benefits to Tasmania, of Forestry Tasmania	Evaluates Forestry Tasmania's long-term financial and economic performance.
Speed detection devices	Evaluates Tasmania's speed detection devices enforcement program looking at the efficiency and effectiveness of the program.
Communications by the government	Tests whether advertising, public surveys and websites are used for the benefit of Tasmanians and not for political purposes.
Teaching of science in public high schools	Examines the quality of science teaching in Tasmanian high schools.
Public servants not working	Looks at the trends, prevention and management of stress leave, long term sick leave, suspension and poor performance.