S O U T H A U S T R A L I A

Report

of the

Auditor-General

for the

Year ended 30 June 2000

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Supplementary Report

Electricity Businesses Disposal Process in South Australia: Engagement of Advisers: Some Audit Observations

By Authority: M. G. O'Callaghan, Government Printer, South Australia

2000

Auditor-General's Department

27 November 2000

The Hon J C Irwin, MLC
President
Legislative Council
Parliament House
ADELAIDE SA 5000

The Hon J K G Oswald, MP
Speaker
House of Assembly
Parliament House
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Gentlemen,

Pursuant to the provisions of section 36(3) of the *Public Finance and Audit Act 1987*, I herewith provide to each of you a copy of my Supplementary Report 'Electricity Businesses Disposal Process in South Australia: Engagement of Advisers: Some Audit Observations'.

Yours sincerely,

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EXECUTIVE SUMMARY

Notwithstanding the fact that the sale/lease of electricity assets is now completed, the issues that arose in the course of that process have raised a broad range of matters that have a continuing relevance to public administrative processes in this State.

PART 1
INTRODUCTION TO THE REPORT

1. This Report is one of a series of reports prepared by the Auditor-General in relation to the disposal of the South Australian government-owned electricity assets. The focus of this Report is 'the adequacy of the process' by which the Advisers were selected and engaged, and the way in which the resulting contracts for their services are being managed by the Department of Treasury and Finance's Electricity Reform and Sales Unit (ERSU).

2. I should emphasise that the comments in this Report are not intended to reflect on the activities of, or the advice provided by, the Advisers.

3. The Report sets out the issues I have identified in relation to each Adviser and my recommendations in respect of each issue. However, there are some issues that I believe are of fundamental importance and to which I have drawn particular attention, namely:

   - the failure by the ERSU to adhere to the Department of Treasury and Finance's guidelines for the engagement of consultant services;
   - the dilution of the State's standard terms and conditions for contracts entered into with some Advisers;
   - the inherent risks associated with the use of 'success fees';
   - instances where there is an absence of documentation to support decisions in the selection process;[1]
   - the failure to finalise contract documentation prior to the commencement of services;
   - the adequacy of contractual arrangements for managing conflicts of interest.

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[1] Failure to document and thus deny the opportunity for an audit/review trail of the processes can undermine public confidence where there is the potential for unfairness/partiality to occur in the appointment process. Where there is no documentation there is no opportunity for independent assurance that the core governmental administrative values of accountability, transparency, etc have been satisfied and in such circumstances the control environment must be regarded as inadequate.

4. I have consolidated these issues in this Part of the Report because, in my opinion, the presence of these issues increases the risks inherent in all aspects of the contractual arrangements with the Advisers.

PART 2
THE PROCESS FOR THE SELECTION OF ADVISERS

5. In February 1998, the Government approved the Electricity Reform and Sale Program, and advertised for the submission of proposals from those parties interested in providing advice in relation to that program.

6. As none of the proposals put forward a consortium capable of providing the skills needed to address all the areas mentioned in the Request for Proposal (RFP), the Treasurer decided to select a lead adviser and then engage other consultants as needed for the remaining subject areas, including:

- Legal
- Accounting
- Actuarial
- Communications
- Economic
- Engineering
- Environmental
- Project Management.

7. All proposals were initially reviewed by a review team against identified criteria, with final interviews and a recommendation for approval by the Treasurer made by a Selection Panel of senior government officers.

PART 3
REQUEST FOR PROPOSAL (RFP)

8. The advertisement seeking proposals for the Advisers was published on 18 February 1998 and stated that the closing date for receipt of proposals was 27 February 1998. The commencement date for key advisers was proposed as 9 March 1998. A contract with the appointed Lead Advisers was not signed, however, until 15 April 1998.

9. The specified dates, in my opinion, created a very short period for potential service providers to prepare and submit their proposals, and for the Government to assess all proposals, shortlist and interview the 'most suitable' service providers, and negotiate contractual terms with the successful Advisers before they commenced work.

10. For the maintenance of credibility in government procurement, it is my opinion that it is a better practice to publish and adhere to realistic timeframes.

11. Further, I am of the opinion that the lengthy contract negotiations that occurred would have been reduced by inclusion in the RFP of a complete set of terms and conditions for the contract to be entered into by the Treasurer and each of the Advisers.

PART 4
PRE-SUBMISSION DISCUSSION

12. Audit noted that a meeting was held with one proposer a few days before proposals were due for lodgement, even though requests for meetings were refused with other potential proposers in the period up to lodgement of proposals.

13. Although Audit has been advised that it was not expected that a proposal would be received from that proposer, it highlights the need to ensure that protocols are drawn up to govern the contact arrangements with potential bidders during an RFP process.

PART 5
EVALUATION OF RESPONSES TO THE REQUEST FOR PROPOSAL

14. A number of the proposals were either received late, or were deficient in addressing all the requirements of the RFP and required supplementary material to be submitted after the closing time for proposals.

15. I am concerned that, although there is no evidence of any substantive unfairness to any of the potential advisers by the admission of either the late proposals or the supplementary material to the evaluation, there can be a perception of unfairness in such admission.

16. There is no documented evidence of any consideration given to whether the late submission of proposals or material afforded a proposer an advantage over others, or as to whether they should have been excluded from further consideration.

17. In addition, it is important in conducting government procurement processes to ensure that the selection criteria used to evaluate submissions are consistent with the terms of the process notified to participants, in this case through the RFP document.

18. I noted, however, that the selection criteria identified to evaluate proposals did not refer to conflicts of interest, (which was an aspect on which proposers were asked by the RFP to respond) but did, on the other hand, refer to local South Australian content (which was not an aspect referred to in the RFP).

PART 6
CONTRACT FORMATION

19. A specification or consultancy brief serves as both a planning and control mechanism for a project. The specification, in the last resort, is also the document protecting the State's legal rights.

20. In a number of the contracts, there was, in my opinion, a failure to draw up a comprehensive Services Specification and annex it to the Agreements with the Advisers.

21. The Agreements dealt with the issue of 'conflict of interest' in different ways. In a number of cases the ability to terminate the contract only applies to 'actual' conflict of interest, and not a 'perceived' conflict of interest.

22. The perception that a conflict of interest exists can, however, be as damaging to the disposal process as an actual conflict. If there was a perception or a potential conflict of interest on the part of the Adviser that could undermine the disposal process the only apparent contractual solution is for the Treasurer to terminate the Agreement for convenience. In such a case the compensation arrangements favour the Advisers.

23. The Agreements with the Advisers are of significant value and relate to the provision of advice on which the State was to place significant reliance. In my opinion, the State should have been, but was not in all cases, indemnified by the Advisers in respect of loss or damage suffered by the State as a result of the services provided.

24. Although the requirement for the Advisers to provide an indemnity to the Government was clearly stated in the RFP, in a number of cases (including the contract with the Lead Adviser) the indemnity was excluded from the Agreement.

25. With respect to the professional indemnity insurance cover required to be maintained by the Advisers, the arrangements differed from Agreement to Agreement. The Report recommends that the arrangements could have been improved by:

- requiring any parent companies providing 'self-insurance' cover to be part of the Agreement;
- where possible, the State obtaining and reviewing the individual insurance documents to ensure that the State's interests are protected;
- documenting the assessed level of insurance required by an individual Adviser.

26. The Agreements formed with each of the Advisers contain different clauses with respect to termination of the contract:

- by the Treasurer without cause;
- by the Adviser without cause;
- for abandoning the project.

27. In a number of cases the clauses for termination were, in my opinion, either unreasonably generous to the Adviser, or did not fully compensate the State where the Adviser may need to be replaced.

PART 7
CONTRACT MANAGEMENT

28. It was evident that a number of individual Advisers had commenced work for the Government prior to the finalisation of their engagement contract. In my opinion, that situation is far from ideal. The very pressures that make it tempting to allow an Adviser to start work before a contract is signed serve to potentially weaken the State's bargaining position.

29. The disposal process was 'on hold' for the period between December 1998 and June 1999 because there was no legislation to support the process. The Lead Advisers contract was not suspended, as was provided for in the contract, until April 1999. Further, with respect to the Accounting Adviser's contract that had also been suspended, the Government did not seek any assurances at the time of reactivation of the contract as to whether any conflicts of interest had arisen during the period of suspension.

30. Audit noted that there has been a number of conflict of interest issues that have arisen during the course of the disposal process that were dealt with by the ERSU. Their resolution did, however, give rise to two issues, namely:

- whether the substitution of a nominated person by one of their employees adequately removes a conflict of interest, given the employer/employee relationship that would continue to exist;

- whether the Government should pursue compensation for additional costs incurred where the Adviser was required to withdraw because of a conflict of interest.

SUMMARY OF RECOMMENDATIONS

The following recommendations have been made in this Report.

Audit Recommendation 1

In planning processes to select consultants, I recommend consideration be given to whether the process to be used is capable of meeting the advertised deadline which must be a reasonable deadline in the circumstances.

Audit Recommendation 2

I recommend that RFP documentation provide information on all matters likely to significantly impact on submissions, including, the key terms and conditions for any resulting contract.

Audit Recommendation 3

I recommend that as part of the planning process for the conduct of an RFP, protocols be drawn up to govern contact with potential bidders during an RFP process.

Audit Recommendation 4

I recommend the establishment of promulgated guidelines to assist agencies required to develop contractual relationships involving an RFP process.

Further, I recommend that a statement be included as a standard term of all procurement process documents as to whether, and in what circumstances, a late proposal or late material will be considered.

Where a late proposal or late material is received, I recommend that any decision to admit or not admit that material to the evaluation be documented.

Audit Recommendation 5

I recommend that the selection criteria to be applied for any government procurement process be identified, documented, and communicated to potential proposers through the procurement process documents.

Audit Recommendation 6

I recommend that in future consultancies selection criteria be subject to quantitative as well as qualitative assessment.

Audit Recommendation 7

I recommend that any RFP require proposers to provide information as to any current litigation, investigations, charges etc in which they or their company, their parent company or subsidiaries are involved.

Further, I recommend that a verification of the bona fides of proposers form part of the evaluation process in any RFP process for the selection of a consultant for a significant role in a project of public importance.

Audit Recommendation 8

I recommend that procurement processes be structured to allow for the full consideration of all relevant issues and to avoid self-imposed pressures (eg time) that confer potential bargaining strength in negotiations to the other party.

Audit Recommendation 9

I recommend that where concessions are made in contract negotiations the reasons for making those concessions (including an assessment of the benefits obtained) be clearly documented.

Audit Recommendation 10

I recommend that in contracts for advisory services, the services to be performed and outcomes to be achieved be fully described.

Audit Recommendation 11

I recommend that contracts for advisory services provide a mechanism for resolving potential and perceived conflicts of interest, should they arise. In this respect I recommend that consideration be given to inserting an express contractual term in the State's standard Consultancy Agreement to the effect that the consultant will not only notify any conflict (whether actual, potential or perceived) but also take whatever steps are required to address that conflict.

Audit Recommendation 12

I recommend that significant consultancy contracts contain an express prohibition on the consultant acting for any interested third party (whether that interest is direct or indirect) in circumstances where an actual, potential or perceived conflict of interest could arise.

Audit Recommendation 13

I recommend that the State obtain an indemnity from any consultant providing expert advice where the contract is high value and reliance will be placed on the advice, such that the State is potentially exposed to liability should that advice prove to be defective.

Audit Recommendation 14

I recommend that where a proposer, who has been selected subject to contract negotiation, deviates significantly from the initial offer in those negotiations, the proposal be re-evaluated against other proposals, taking into account the deviation.

Audit Recommendation 15

I recommend that where the Crown Solicitor's Office provides advice on contractual matters, particularly in relation to the liability to be assumed by the State, that advice be appropriately documented.

Further, I recommend that where a contract is prepared by the Crown Solicitor's Office, that contract be based on instructions from the requesting party (documented by the Crown Solicitor or the instructing party).

Audit Recommendation 16

I recommend that all significant consultancy agreements, particularly those with a high risk exposure, or where there is a cap on liability, be referred to SAICORP for review.

Audit Recommendation 17

I recommend that agreement to cap liability should only be given after a full risk assessment has been undertaken and documented, showing why a cap is justified and what the size of the cap should be in order to best protect the State.

Audit Recommendation 18

I recommend that consideration of the fee structure to apply under consultancy contracts be undertaken during the evaluation and selection of advisers. Where fee structures need to be negotiated, this should be done at a stage when the competition between proposers is still active.

Audit Recommendation 19

I recommend that a success fee arrangement only be agreed for the engagement of a consultant where it is demonstrably in the interests of the State to do so, ie a success fee arrangement will ensure a better outcome for the State or the State cannot obtain the necessary consultancy services without agreeing to a success fee arrangement.

I further recommend that the rationale for entering into a success fee arrangement be clearly articulated and documented for accountability purposes.

Audit Recommendation 20

I recommend that where a success fee arrangement must be used in order to engage a consultant, consideration be given to establishing other measures to ensure the advice received is not unduly influenced by the opportunity to receive an incentive.

Audit Recommendation 21

I recommend that contracts for consultants/advisers include firm contractual arrangements to apply to all events that could reasonably be expected to occur.

Audit Recommendation 22

I recommend that where a parent company is effectively taking the place of the insurer, consideration be given to making the parent company a party to the contract.

Audit Recommendation 23

I recommend that the State, for all consultancies where the State's exposure in the event it receives incorrect advice is potentially significant, obtain, where possible, copies of all relevant insurance policies from the consultant to verify that the insurance arrangements are satisfactory to protect the State's interests.

Audit Recommendation 24

I recommend that the State, for all consultancies where the State's exposure in the event it receives incorrect advice is potentially significant, conduct a risk analysis to determine what insurance arrangements the contracted party needs to have in place to protect the State's interests.

Audit Recommendation 25

I recommend that:

(a) the State only agree to self insurance arrangements in circumstances where the State's potential liability exposure as a result of defective advice is low and the benefits of employing the Consultant otherwise outweigh the detriment of self insurance, or the risks are effectively uninsurable;

(b) the State not accept the self insurance of a contractor unless it is satisfied that the self insurance arrangements will be able to be enforced within South Australia in a similar manner to an insurance policy.

Audit Recommendation 26

I recommend that provisions for payment of consultants in circumstances where contracts are terminated by the State without cause be formulated on the basis that the payment is to be reasonable compensation for work performed and liabilities incurred to the date of termination and not in respect of any anticipated profit to be made on the project.

Audit Recommendation 27

I recommend that consultants not be given rights to terminate without cause, or where these must be conceded, that an obligation to fully compensate the State for the costs of engaging an alternative adviser be included.

Audit Recommendation 28

I recommend that it be a basic principle of government procurement that no goods or services be delivered until a written contract is in place. Where a contractor or consultant must commence delivering goods or services prior to a written contract being in place, I recommend that the terms of the contract be negotiated and the contract be executed as soon as reasonably practical.

I also recommend that, in such circumstances, there be an express provision in the contract that makes clear that the contract is intended to operate retrospectively to the date when the goods or services were first delivered.

Audit Recommendation 29

I recommend that an appropriate contract management system be established for every material contract to ensure variations are negotiated and formalised in a timely manner.

Audit Recommendation 30

I recommend that where it is proposed to allow consultants to work for others during a period of suspension without government consent, the terms of the suspension must also outline a process for reactivation that provides for assurances as to conflict of interest and allows for termination in the event a potential or actual conflict of interest is identified.

Audit Recommendation 31

I recommend that where an agreement is entered into on the basis of assumptions which if later proved incorrect will entitle the contractor to negotiate changed fee arrangements, the assumptions in question must be fully documented so that it is possible to determine whether any fee increase is warranted from an objective review of the documentation.

Audit Recommendation 32

I recommend that consideration be given to seeking compensation from the Lead Adviser because of the unavailability of key personnel through a conflict of interest.

Audit Recommendation 33

I recommend that the State, as a matter of practice and procedure, conduct detailed probity and background checks against all contractors bidding for significant consultancy contracts which have the potential to give rise to significant liability exposure for the Government.

Audit Recommendation 34

I recommend that where a Probity Auditor is employed in disposal processes the State should strictly comply with any course of action recommended by the Probity Auditor to deal with conflict of interest issues. Any decision to deviate from a course of action recommended by the Probity Auditor must be fully documented. Such documentation must include a written record of any other professional advice on which the State based its decision to deviate.

Audit Recommendation 35

I recommend that an appropriate contract management system be established for material consultancies, and that such a system include regular formal reviews of the performance of the consultant as against the key terms of the contract.

GLOSSARY OF TERMS

Agreements	The Consultancy Agreements between the Treasurer and each of the Advisers.
Disposal Act	*Electricity Corporations (Restructuring and Disposal) Act 1999*.
Disposal Process	The process adopted and managed by the ERSU for the disposal of the government-owned electricity businesses.
ERSU	The Electricity Reform and Sales Unit of the Department of Treasury and Finance.
Project	The program established by the South Australian Government for the reform of the electricity supply industry in this State and the disposal of the government-owned electricity assets.
RFP	Request for Proposal.
SAICORP	South Australian Government Captive Insurance Corporation.

ELECTRICITY BUSINESSES DISPOSAL PROCESS IN SOUTH AUSTRALIA: ENGAGEMENT OF ADVISERS: SOME AUDIT OBSERVATIONS

PART 1
INTRODUCTION

1.1 SCOPE OF THIS REPORT

This Report is one of a series of reports prepared by the Auditor-General in relation to the disposal of the South Australian government-owned electricity assets.

This Report examines the process by which the Government's Advisers were selected and contracted by the Electricity Reform and Sales Unit of the Department of Treasury and Finance (ERSU) and the arrangements in place for the management of those contracts by the ERSU. It is relevant to note that the Advisers were engaged by the Government to advise in relation to the disposal of all of the government-owned electricity assets. The Report covers the selection and engagement of the following Advisers:

- principal business advisers, Morgan Stanley Pacific Road Consortium (the Lead Advisers);
- accounting and financial adviser, KPMG Corporate Finance (Vic) Pty Ltd (in this Report referred to as the Accounting Adviser);
- legal adviser, the consortium of Arthur Robinson & Hedderwicks/Allen Allen and Hemsley/Finlaysons (the AAR Group) and Johnson Winter and Slattery (JWS) (in this Report referred to as the Legal Advisers);
- the Actuarial Adviser, William H Mercer Pty Ltd (in this Report referred to as the Actuarial Adviser or 'Mercers');
- the 'strategic' Communications Adviser, Walmarringin Pty Ltd, which trades as Business Development & Communication Network (in this Report referred to as the Communications Adviser or 'BDCN');
- the Economic Adviser, Putnam Hayes and Bartlett (in this Report referred to as the Economic Adviser or 'PHB');
- the Engineering Advisers, Sinclair Knight & Merz, and Burns and Roe Worley (in this Report referred to as the Engineering Advisers or 'SKM' and/or 'B&RW' respectively);
- the Environmental Consultants, Hyder Consulting (Australia) Pty Ltd and Energetics Pty Ltd (in this Report referred to as the Environmental Consultants or 'Hyder' and/or 'Energetics' respectively);
- the Project Manager, Kinhill Pty Ltd (in this Report referred to as the Project Manager or 'Kinhill').

At the time of preparing this Report, the ERSU's actual management of the abovementioned Consultancy Agreements for the full term has not been completely reviewed.[2] Further issues relating to the actual management of the Consultancy Agreements may therefore be raised by Audit at a later stage. However, for the purposes of this Report, Audit has reviewed the adequacy of the current arrangements in place for the management of the Agreements and has also raised some issues relating to actual contract management to-date.

The process for the selection and appointment of, and establishing conditions of contract for, the Advisers is an important task in the review of the overall probity of the disposal process. While the Advisers do not themselves make decisions as to the disposal of the electricity assets, many of them are, nonetheless, in a position of significant influence in their relationship with those making the key decisions relating to the disposal of those assets. Secondly, the fees payable to the Advisers are a significant sum, even in the context of the overall receipts obtained from the disposal process. It is, therefore, important to understand the obligations of each set of Advisers and the incentives for their remuneration that may influence the advice provided by them.

1.1.1 Matters of Emphasis

I should emphasise that the comments in this Report are not intended to reflect on the activities of, or the advice provided by, the Advisers. The focus of this Report is 'the adequacy of the process' by which the Advisers were selected and engaged, and the way in which the resulting contracts for their services are being managed by the ERSU at the date of this Report.

The ERSU have indicated in their response to the issues raised by me[3] that in some instances their approach to the conduct of the process reflected their commercial judgment, which they acknowledge led them to decisions that differed from my recommended approach. I agree that it is quite legitimate for differences to exist in relation to the approach to commercial issues. However, the recommendations contained in this Report reflect my view regarding those governmental values of accountability, transparency and auditability etc that should always be the basis upon which governmental activities are predicated.

1.2 MAJOR ISSUES

The Report sets out the issues I have identified in relation to each Adviser and my recommendations in respect of each issue. However, there are some issues that I believe are of fundamental importance and to which I wish to draw particular attention. Commentary on these issues follows.

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[2] A review of correspondence and other matters passing between the ERSU/Treasurer/Advisers subsequent to the disposal of ETSA Utilities Pty Ltd and ETSA Power Pty Ltd is yet to be completed.

[3] Forwarded under covering letter dated 31 August 2000 from the Under Treasurer.

1.2.1 Lead Advisers

In respect of the Lead Advisers these issues are:

- the conduct of negotiations with the Lead Advisers;
- aspects of the management of the Lead Advisers contract by the ERSU;
- the contractual obligations and the basis for payment of a 'success fee'.

In my opinion, the issues identified in this Report show the procedures adopted by the ERSU in engaging the Lead Advisers were not consistent with the Department of Treasury and Finance guidelines for such processes. Further the ERSU did not adequately deal with the situation that arose where the preferred proponent changed its position in relation to acceptance of the Government's standard terms and conditions. The lack of regard for the Department of Treasury and Finance guidelines in conducting a process of the magnitude of engaging the Lead Advisers is a matter which can objectively be said to be likely to give rise to public concern. The tendency inherent in government arrangements to give rise to public concern can undermine public confidence in the processes of public institutions.[4]

1.2.1.1 The Conduct of Negotiations with the Lead Advisers

This issue arose from the position adopted by the ERSU in respect of the failure of the Lead Advisers, during negotiation of the contract, to fulfil a representation made in their response to the Request for Proposal (RFP). The representation by the Lead Advisers was as follows: 'The organisations confirm that there are no areas within the State's standard terms and conditions of contract with which they are unable to comply'.[5]

When it came to entering into a contract, the Lead Advisers did not commit to the provision of an indemnity in favour of the Government regarding liability arising from the performance of their work as required by the Consultancy Terms and Conditions set out in the RFP.

Further, the ERSU did not obtain a commitment from the Lead Advisers to other standard terms and conditions such as:

- the provision to allow the determination of liability in accordance with the common law;

- the maintenance of insurance to cover the potential liability of the Lead Advisers.

Instead, the Lead Advisers sought and obtained a limit on their liability, and self-insured that liability.

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[4] The matter of the tendency inherent in the procedures of government to undermine public confidence in processes of public institutions was discussed in the 1996 Report of the Auditor-General — 'Part 3 — SA Water Corporation — Audit Report of the Procedures Associated with the Receipt, Opening and Distribution of the Final Submissions on 4 October 1995' at p vii.

[5] Paragraph 9 of the consortium's proposal dated 27 February 1998.

The significance of this matter arises from the fact that another proponent's failure to agree to the Government's standard terms and conditions in relation to liability caps was one reason for the ERSU not considering their proposal further. Although there were other reasons for not selecting that proponent, it is my opinion, that, had the Government been aware of the preferred Lead Advisers' stance with respect to the issue of indemnities during the initial evaluation, the Government may have proceeded to negotiate with other parties.

To allow a proponent to change its position without re-evaluating the impact of the change is, in my opinion, at the least unfair as regards other proponents and probably improper. I make recommendations in this Report as to how future processes may be run so as to ensure that the evaluation and selection of advisers is based on an appropriate level of information as to the terms and conditions to which the appointment of advisers would be subject. These recommendations are discussed in this Report in 'Part 5 — Evaluation of Responses to Request for Proposals (RFPs)'.

1.2.1.2 Aspects of the Management of the Lead Adviser Contract by the ERSU

The second major issue relates to the ERSU's management of the Lead Advisers' contract. In my opinion, for the reasons expressed in this Report, the system in place for the management of the Lead Advisers' contract is not in accordance with the Department of Treasury and Finance Guidelines for the Use of Consultants/Contractors.

The ERSU failed to enforce terms of the contract designed to reduce the fees payable to the Lead Advisers in certain circumstances, resulting in fees paid to the Lead Advisers being greater than they may otherwise have been. This issue is discussed in this Report under the heading '7.2 — Suspension of the Contract'. Further, the non-availability of a key member of the Lead Advisers because of a conflict of interest created a situation for there to be a significant impact on the project. This issue is discussed in this Report under the heading '7.4.1 — Conflict of Interest of a Lead Adviser'.

1.2.1.3 The Contractual Obligations of the Lead Advisers and the Basis for Payment of a Success Fee

The greater the 'degree of risk' to be assumed by the State, the greater the potential 'price' to be received for the asset and hence, the greater the reward for the Lead Advisers under the success fee arrangement.

The analysis of risk that was to be made, was to be made not only against pre-established benchmarks, but also against risks that were not subject to pre-established benchmarks and where the benchmarks with respect to the latter mentioned risks were to be determined only after the bids had been received and opened. In my opinion, in these circumstances, where the State would be reliant upon the advice of the Lead Advisers regarding acceptance/commerciality of risk, the arrangements established by the ERSU did not reflect sound administrative practice, and in fact, placed the State in a potentially prejudicial position.

As a matter of principle, to structure a complex asset disposal process involving the payment of a success fee based on 'price' with the same persons who are entitled to the success fee having a concurrent responsibility to analyse the commercial acceptability of the impact of risks to be assumed by the State arising out of the disposal is, in my opinion, not only an unsafe administrative arrangement but also inconsistent with good administration practice.

The pervasive nature of the advice required of the Lead Advisers within the disposal process cannot be said to have been counter-balanced by the influence of other advisers.[6] Although there were other advisers who have specific responsibilities, eg legal, accounting, etc, the Lead Advisers were in a strategic overarching role.[7]

The inherent temptation to maximise 'the price' and to not have adequate regard to the issues arising from the assessment of risk is, in my opinion, an unacceptable arrangement. The tendency of the operation of this contractual relationship in these circumstances, particularly in the absence of transparent and effective contract and risk management processes, is such as to be a matter of concern.

1.2.2 Accounting Adviser

In respect of the Accounting Adviser, the issue is the incorporation of a success fee reward structure into the Consultancy Agreement with the successful Accounting Adviser.

In contracting the Accounting Adviser, the State negotiated a 'success fee' (or 'incentive bonus') which could result in the Accounting Adviser receiving payment of a significant amount over and above their daily fees if, for example, disposal proceeds reach $6 billion. There is no documented rationale as to why it was considered necessary for the State to agree to such a payment.

Given the services to be provided by the Accounting Adviser (which also included the provision of financial restructuring and undertaking due diligence and limited evaluation activities), I am of the opinion that the role played by the Accounting Adviser could not be seen to have actively contributed to the achievement of potentially increased disposal proceeds and hence warrant the payment of a form of incentive bonus.

I note that while the Accounting Adviser's response to the Request for Proposal for advisers for the disposal process issued by the State did indicate that a 'success fee' would be sought, the responses received from the majority of general accounting advisers did not. The ERSU advised[8] Audit that the appointed Accounting Adviser was preferred because of their recent Victorian electricity industry experience. Further, the ERSU considered that the

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6 Notwithstanding the fact that the ERSU claim that the Lead Advisers did not exercise a pervasive influence and that the actual decision-making was made by the Treasurer, on the basis of all the evidence available to me, I am not persuaded that this is the case.

7 It is to be noted that the public briefing associated with the disposal process, although it involved certain other specialist speakers, eg the legal advisers the Lead Advisers featured more prominently than these other specialist advisers.

8 Conference between Audit and the ERSU on 6 July 2000.

way in which the disaggregation of the electricity businesses was undertaken would be a key to the eventual proceeds from their disposal, and thus the Accounting Advisers could contribute to the overall profitability of the disposal process. The ERSU also commented that through negotiations, the hourly rates were lowered as a trade off for the success fee. These matters, however, were not documented at the time the selection process was undertaken.

I consider that the incorporation of a success fee reward structure into the contract with the successful Accounting Adviser is, having regard to the role of the Accounting Adviser, inappropriate. Further, I am of the opinion that the use of such a reward mechanism needs to be carefully considered by the State in all future engagements of advisers.

It may be argued that the 'success fee' component is a relatively modest sum compared to projected overall disposal proceeds. However, I take the view that the amount is potentially significant, particularly when added to the Accounting Adviser's daily rates. Given this position, in my opinion, good administrative practice requires the reasons for agreeing to such a course of action to be clearly identified and documented. This is particularly so as there is the potential to create a precedent for the future engagement of advisers on similar projects.

In my opinion, the payment of a 'success fee' should not have been agreed to, unless it could be demonstrated to be clearly in the best interests of the State, ie the successful Accounting Adviser was the only accounting firm able to perform the consultancy services to the required standard and would not have contracted without the success fee component. The fact that the Accounting Adviser (or other accounting firms) may have been able to negotiate a 'success fee' component in other privatisation exercises does not in itself justify the State agreeing to such a 'success fee' component in this case.

The issue of this 'success fee' is further examined under the heading '6.6 Success Fees and Monthly Retainer' in this Report.

1.2.3 Legal Advisers

In relation to the Legal Adviser, the issue relates to the failure to document selection evaluation decisions.

The initial evaluation of Legal Advisers' proposals was undertaken by a review team made up of senior officers from the ERSU. This initial evaluation divided the proposals into three categories according to their experience. The review team recommended to a selection panel that the panel interview the four legal firms/legal consortia which it had ranked as 'Category 1 shortlisted candidates' (ie those demonstrating experience and involvement in electricity law matters). Notwithstanding the review team's recommendation, the Selection Panel also interviewed some legal firms/legal consortia assessed by the ERSU review team as being in Category 2 (ie not demonstrating sufficient experience in electricity law). There is no documentary evidence supporting the decision to interview some legal firms/legal consortia from Category 2.

The final selection of the Legal Advisers involved the combination of legal firms from separate proposals. The rationale for the 'mixing and matching' that took place in forming the group that was chosen as the Legal Advisers was not documented.

The failure to fully document the evaluation and selection processes does not represent a good public administrative practice and may have a tendency to undermine public confidence in government procurement processes. Where decisions are made by government officials that have the potential to advantage one party as against another there is, as a matter of law in practically all cases, a requirement of impartiality in decision-making. The absence of adequate documented reasons for a particular selection/appointment prevents independent review and confirmation that relevant public law requirements have been satisfied.

The evaluation process for the selection of the Legal Advisers is discussed in this Report under the heading '2.4.3 — Legal Advisers'.

1.2.4 Other Advisers

The two issues relating to Other Advisers are:

- the requirement for a formal contract;
- conflict of interest

1.2.4.1 Requirement for Formal Contract

The fact that formal Consultancy Agreements were not entered into with the successful actuarial, communications, economic, engineering, environmental and project management advisers until the advisers commenced performing services is an issue which I consider warrants attention. In some cases (eg the Engineering Advisers) the Consultancy Agreements were not formalised for a period of several months after the advisers commenced performing services. In only one case (the Actuarial Adviser) was the Consultancy Agreement drafted to have retrospective effect.

The legal basis on which the successful actuarial, communications, economic, engineering, environmental and project management advisers were performing services until the date on which their respective Consultancy Agreements were formalised and entered into is not clear to me.

Advisers performing services prior to the execution of Consultancy Agreements is a recurring issue. It is an issue fundamental to accountability and proper contract management. In my opinion, it is a highly unsatisfactory situation that represents poor contract management. The rationale for the usual government contracting requirement that a written contract be in place before goods or services are delivered is that a written contract provides certainty and minimises the scope for dispute about contractual terms, thereby protecting taxpayers' interests. Moreover, if a consultant commences performing services before the Consultancy Agreement is formalised this potentially confers significant

bargaining strength on the consultant in terms of negotiating the contractual terms and conditions. The relevant Department of Treasury and Finance Guidelines and Government Management Board Policy & Guidelines clearly state that significant consultancies must be performed pursuant to formal contracts.

I acknowledge that it is not unusual for a consultant to commence providing services before a formal contract is agreed where the need for consultancy services is urgent and immediate. In such a case accountability principles and proper contract management require that the basis on which the consultant commences providing services is clear and the terms of the consultancy agreement should be negotiated and the agreement executed as soon as is practicable. However, the pace at which some of these Consultancy Agreements were negotiated after the consultants commenced services was at best leisurely. For example, according to its Consultancy Agreement, one of the Engineering Advisers commenced performing services on 5 June 1998 but the Agreement was executed by the Treasurer on 14 October 1998.

This issue is discussed in greater detail in this Report under the heading '7.1 — Commencement of Services'.

1.2.4.2 Conflict of Interest

The Consultancy Agreements with the successful actuarial, communications, economic, engineering, environmental and project management advisers all provide that the Treasurer can terminate the Agreement if the consultant has an actual conflict of interest. However, none of the Consultancy Agreements contain a mechanism for dealing with perceived conflicts of interest. Advice from the Chief Commercial Counsel, Crown Solicitor's Office to the ERSU confirmed that unless an adviser has an actual conflict of interest or breaches confidentiality the State can do nothing.[9] In my opinion, this is a highly unsatisfactory situation. I have previously made the point that the perception of a conflict of interest can be as damaging to the disposal process as an actual conflict and can found a legal challenge.[10]

This conflict of interest issue is discussed in greater detail in this Report under the heading '6.3 — Contract Terms Dealing with Conflicts of Interest'.

1.3 PROCESS FOR OBTAINING INFORMATION AND COMMENTS FROM THE ERSU

Audit commenced the review process in respect of the engagement of advisers by reviewing material held on the ERSU files. After an initial review, written requests for documents not available from the reviewed files were sent to the ERSU and further documentation and information was obtained as a result.

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9 See discussion in this Report under the heading '6.3 — Contract Terms on Conflict of Interest'.

10 See Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Arrangements for the Probity Auditor and Other Matters: Some Audit Observations', p 26.

In addition, a number of meetings were held between Audit, the ERSU and on one occasion, Crown Law. At these meetings, and in subsequent written responses, information about the process by which the Advisers were engaged was provided to Audit. This information was relied upon by me to form opinions about issues identified through the review.

As a result of the above process, Audit provided a draft of the issues to the ERSU for comment. The comments received from the ERSU were considered in formulating the observations and recommendations included in this Report.

1.4 STRUCTURE OF THIS REPORT

This Report is in seven (7) separate Parts.

Part 1 provides an introduction to the Report.

Part 2 sets out a brief description of the process undertaken to request and evaluate proposals from prospective service providers.

Parts 3, 4, 5, 6 and 7 comment on key issues in relation to the selection, contracting and management of Advisers.

1.5 AUDIT MANDATE

Subsection 36(3) of the *Public Finance and Audit Act 1987* provides:

> *The Auditor-General may, if the Auditor-General thinks fit to do so, prepare a supplementary report (and annex documents to it) relating to a matter required to be dealt with in an annual report and deliver that report to the President of the Legislative Council and the Speaker of the House of Assembly.*

This Report has been prepared on the basis of the mandate provided by subsection 36(3) of the *Public Finance and Audit Act 1987* as described above.[11]

[11] My obligations in respect of section 22 of the Disposal Act will be dealt with in a later report.

PART 2
BACKGROUND: THE PROCESS FOR SELECTION OF ADVISERS

This Part of the Report sets out a brief description of the process undertaken to request and evaluate proposals from prospective service providers.

2.1 ISSUE OF A REQUEST FOR PROPOSAL (RFP)

On 16 February 1998, Cabinet approved the Electricity Reform and Sale Program.

On 18 February 1998, the South Australian Government advertised[12] for the submission of proposals by 27 February 1998 from those parties interested in providing advice to the Government in relation to the Electricity Reform and Sale Program, in the following subject areas:

- Project Management
- Corporate Governance
- Commercial and Financial
- Accounting and Taxation
- Legal
- Economic Analysis
- Regulatory Analysis
- Environmental
- Communications and Public Relations.

An RFP document was prepared and issued to those parties responding to the advertisement.

2.2 CONTENTS OF THE RFP

The RFP stated that:

> *The reform program is planned to consist of three stages and is expected to be completed over a two year period:*
>
> - *a three month information gathering and detailed study of proposed reforms and business structure;*
> - *a period of implementation of the reforms and for restructuring Optima Energy and ETSA Corporation over three to nine months;*
> - *the sale of the businesses over approximately a one year period.*

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[12] Advertisements appeared in The Advertiser and The Australian Financial Review.

Further, the RFP stated that the Department of Treasury and Finance:

> *… wishes to appoint a group of reform and financial advisors to work with the ERSU to give effect to the reform objectives and eventual sale of the Government owned electricity assets in South Australia.*

Proposals were invited from organisations wishing to provide advice in specific areas and from organisations/consortiums of organisations able to cover the range of activities.

The functions of the advisers were listed in the RFP document as follows:

> *The advisors are to assist the reform program by:*
>
> 1. *Providing project management services for the information gathering, reform, business restructuring and sale phases;*
> 2. *Developing the regulatory framework to support the ESI;*[13]
> 3. *Developing submissions to and liaison with the ACCC,*[14] *NEMMCO,*[15] *and NECA;*[16]
> 4. *Developing the tariff structures for the reformed ESI;*
> 5. *Developing a structure to be reflected in appropriate legislation structures;*
> 6. *Providing Taxation advice to support industry reform;*
> 7. *Providing valuation and accounting advisory services to enable the independent review of the performance of the existing industry structures;*
> 8. *Reviewing the short and medium term capital expenditure plans of Optima and ETSA to identify the least cost but highest quality approach to infrastructure development in the State;*
> 9. *Advising on the appropriate mechanisms to ensure systems security perform short and long term capacity planning for the State;*
> 10. *Advise on the options for programs to foster the use of demand management, cogeneration and the State's renewable energy resources as part of the National Greenhouse strategy;*
> 11. *Advising on appropriate industry and organisational structures for the ESI;*
> 12. *Financial and corporate advisory services to support the sale of ESI assets including:*
>   - *advice on methods of structuring to maximise value to the State from the reform program.*
>   - *identifying a pool of buyers for the ESI assets.*
>   - *assisting in negotiations with potential buyers.*
> 13. *Preparing and implementing a communications and public relations strategy for the information gathering, reform, restructuring and sale processes.*

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13 Electricity Supply Industry.

14 Australian Competition and Consumer Commission.

15 National Electricity Market Management Company.

16 National Electricity Code Administrator.

Under the heading ‘Responses’, the RFP document stated that:

> *Interested advisors are invited to provide a response to this Request for Proposals. Proposals will be considered from organisations able to provide advice in specific areas listed above or from organisations/consortiums of organisations able to cover the range of activities.*
>
> *Responses, not to exceed 10 pages in length, should cover:*
>
> 1. *The issues which the advisor considers central to a successful ESI reform process.*
> 2. *The method by which the advisor proposes to give effect to the Government’s reform program.*
> 3. *The time-frame in which elements of the information gathering, reform, restructuring and sale process can be executed.*
> 4. *The principals to be assigned to this assignment, their availability and location over the information gathering, reform, restructuring and sale period.*
> 5. *Fee structure for each stage of the reform program.*
> 6. *A statement of relevant electricity industry reform experience particularly in the Australian market.*
> 7. *Identify any potential conflicts of interest and how they would be managed in the reform program.*
> 8. *Five relevant industry references who are able to comment on the performance of both the firm and the individuals.*
> 9. *A statement as to whether there are any areas within the State’s standard terms and conditions of contract with which the Consultant is unable to comply. Appropriate contractual arrangements will be entered into including provisions relating to satisfactory performance. The standard terms and conditions may give some guidance.*

Standard terms and conditions of contract were not included in the RFP. Instead, attached to the RFP was a three page document titled ‘Consultancy Terms and Conditions (Generally Indicative Only) (Final Consultancy Terms and Conditions to be set out in a formal Agreement)’.

Particular terms and conditions of note in this document include:

- *clause 1 ‘The Proposals’: ‘The terms and conditions of a formal Agreement are to incorporate the Consultant’s Proposal …’;*
- *clause 6 ‘Termination’: ‘Appropriate termination clauses, recognising key performance milestones and events’;*

- *clause 9 'Indemnity': 'The Consultant must indemnify the Crown, against any loss or damage which either of them suffers as a result of any breach by the Consultant of any of its obligations to the Government under the consultancy';*

- *clause 10 'Time of Essence' 'Time is of the essence in respect of the obligations of the Consultant to the Crown in respect of the Services.'*

On 24 February 1998 a facsimile was sent to all parties who had received the RFP document providing some amendments to the information kit which had previously been distributed and three facsimile numbers that would be available to receive proposals. The following statement also appeared in the facsimile: 'We reserve the right to accept any late proposals. We also reserve the right, if a consortium puts in a proposal to select parts of the consortium'.

2.3 RECEIPT OF PROPOSALS

Audit has been advised[17] that proposals were received at reception or via facsimile machines on the 6th and 8th Floors of the State Administration Centre and that they were immediately taken to the 8th Floor and 'locked up'.

A number of proposals were received by facsimile and in hard copy.

The time of delivery of a proposal was recorded by the ERSU officer receiving the proposal by handwritten note on the sealed envelope in which the proposal was received. All documents remained locked until 28 February 1998 when they were numbered and relocated to a secured office.

Audit noted that nine proposals were received after the closing time of 5.00 pm 27 February 1998. Late proposals were separately identified and not accepted at that stage.

With respect to the procedure applied by the ERSU to determine whether or not these late proposals would be admitted to the evaluation process, Audit was advised that:

> *… the proposals were of a nature where all parties expected submissions and interviews to be required and subsequent negotiation of contracts with the proponent selected through that competitive process.*[18]

It is clear that the ERSU did not view the delivery time specified in the RFP as the final deadline for proposals. This is supported by the statement in the facsimile of 24 February 1998, referred to in section 2.2 above.

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17 Conference with the ERSU officers on 6 April 2000 and letter dated 31 August 2000 from the Under Treasurer covering the ERSU comments on the issues raised by Audit.

18 Letter dated 19 April 2000 from the ERSU to the Auditor-General's Department.

Further commentary with respect to the matter of late submissions is included in this Report under the heading '5.1 — Late Submission of Proposals and Materials'.

2.4 THE EVALUATION PROCESS

2.4.1 Introduction

None of the proposals put forward a consortium that the ERSU considered was capable of providing the skills needed to address all the areas mentioned in the RFP.[19] As a result, the Treasurer decided to select a lead adviser and then engage other consultants as needed for the remaining subject areas.[20]

2.4.2 Lead Advisers

The role of the lead adviser included leading the management and coordination of advice to the Government with respect to the electricity reform and disposal process.

A number of proposals were received and considered by the ERSU for the lead adviser role.

The steps in the evaluation process for selecting a lead adviser were as follows:

- the review team evaluated all proposals considered for the lead adviser role by 4 March 1998 and discussed its conclusions with the Under-Treasurer. The review team drew up a list of potential lead advisers for consideration by a selection panel[21] and in respect of each proposal drew up a list of issues that required clarification or further discussion between the Selection Panel and each proposer;

- the Selection Panel drew up a shortlist of consortia for interview and discussion/negotiation for the lead adviser role. One consortium withdrew from the process before interview;

- the Selection Panel interviewed the consortia on 5, 6, 7 and 9 March 1998. At each interview the Selection Panel raised with the proposer the issues that had been identified by the review team. Where the proposer was not able to provide the information required in respect of these issues at the interview, they were given the opportunity to make further representations/submissions after the interview;

- the Selection Panel made a recommendation to the Asset Sales Cabinet Committee in March 1998;

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19 Refer to list under the heading '2.1 — Issue of a Request for Proposal (RFP)' in this Report.

20 Minute to Consultant Selection Panel — 'Initial Report — Shortlisting of Lead Sale Adviser' dated 4 March 1998.

21 The Selection Panel comprised the Chief Executive, Department of the Premier and Cabinet, the Crown Solicitor and the Under-Treasurer.

- the Asset Sales Cabinet Committee approved the appointment of the Morgan Stanley/Pacific Road consortium as Lead Advisers, subject to negotiation of a suitable contract;

- a draft contract was provided to the preferred Lead Advisers on 20 March 1998.[22] Negotiation of the terms and conditions of the contract occurred in the period 20 March 1998 to 14 April 1998;

- a final contract was signed on 15 April 1998 by the Treasurer and both Morgan Stanley Australia Limited and Pacific Road Corporate Finance Pty Ltd;

- the Premier of South Australia announced the appointment of Morgan Stanley Dean Witter (the US parent of Morgan Stanley Australia Ltd) as Lead Advisers on 15 April 1998.

2.4.3 Legal Advisers

According to the ERSU schedule listing the receipt of proposals, 18 (including two late proposals) were received from separate legal firms or legal consortia.

The documentation reviewed by Audit indicated the following evaluation process:

- A review team, made up of senior officers from the ERSU conducted an initial evaluation[23] of all legal adviser proposals, dividing them into Categories 1 to 3. In its minute to the Selection Panel dated 14 April 1998,[24] the review team recommended that the Selection Panel interview the 4 legal firms/legal consortia which it had ranked as 'Category 1 shortlisted candidates'.

- On 16, 17 and 20 April 1998 the Selection Panel interviewed the four Category 1 consortia, together with another six from Category 2.

- A paper titled 'Issues to be Explored with Legal Advisers at Interview' was used as the 'focus' for questions at the interview, and 'all the candidates were requested to provide, within a day, further details of the staff who would be allocated to the project and various other details specific to the individual proposal'.[25]

- In a minute dated 22 April 1998 the Selection Panel made a recommendation to the Asset Sales Cabinet Committee.

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22 Minute to the Treasurer from the ERSU dated 25 March 1998.

23 The ERSU advised Audit by letter dated 19 June 2000 that it was unable to advise the date or dates on which the review team's evaluation took place.

24 Minute from the ERSU to the Chief Executive, Department of the Premier and Cabinet, the Under Treasurer and the Crown Solicitor dated 14 April 1998.

25 Minute from the ERSU to the Asset Sales Cabinet Committee (through the Treasurer) dated April 1998.

- At its meeting on 22 April 1998, the Asset Sales Cabinet Committee approved the selection of the AAR Group as Legal Advisers.

- A draft contract was provided to the Legal Advisers in April 1998. Negotiation of the terms and conditions of contract occurred in the period April to May 1998.

- The contract is dated 6 May 1998, notwithstanding that the Commencement Date specified in the Schedule of the Contract is 27 April 1998.

Audit Comment

With respect to the interviews of candidates in Category 2 there is no documentary evidence supporting the decision to interview only some but not all legal firms/legal consortia from Category 2.

The final selection of the Legal Advisers involved the combination of legal firms from separate proposals. The rationale for the 'mixing and matching' that took place in forming the group that was chosen as the Legal Advisers was not documented.

The failure to fully document the evaluation and selection processes does not represent a good public administrative practice and may have a tendency to undermine public confidence in government procurement processes for the reasons previously discussed.

2.4.4 Accounting Adviser

Nine proposals were received from general accounting advisers.[26]

The steps in the evaluation process for selecting an accounting adviser were as follows:

- the review team conducted an initial evaluation of all accounting adviser proposals by 14 April 1998 dividing them into Categories 1 to 3.[27] The review team listed three accounting firms in Category 1 for consideration by a selection panel;[28]

- the Selection Panel[29] interviewed the 3 firms on 15 and 16 April 1998. At each interview the Selection Panel raised with the proposer the issues that had been identified by the review team. Where the proposer was unable to provide the information required in respect of these issues at the interview, they were given the opportunity to make further representations/submissions after the interview;

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26 Minutes Forming Enclosure to Evaluation of Consultancy Proposals Accounting Advisors dated 14 April 1998.

27 Officers of the ERSU were unable to advise of a specific date when proposals were evaluated but to the best of their recollection proposals had all been evaluated prior to mid April 1998 — Conference between Audit and the ERSU on 6 July 2000.

28 Minutes Forming Enclosure to Evaluation of Consultancy Proposals Accounting Advisors dated 14 April 1998.

29 The Selection Panel comprised the Under Treasurer; the Executive Director, Commercial and Sale, ERSU; and the Manager, Commercial, ERSU. The Executive Director, Morgan Stanley (Lead Advisers' representative) attended the last interview only as an observer.

- the Selection Panel made a recommendation to the Asset Sales Cabinet Committee by minute dated 22 April 1998;
- the Asset Sales Cabinet Committee approved the selection of KPMG Corporate Finance (Vic) Pty Ltd as the Accounting Adviser, on 22 April 1998;
- a draft Consultancy Agreement was provided to the Accounting Adviser on 23 April 1998.[30] Negotiation of the terms and conditions of the contract occurred in the period 23 April to 30 April 1998;
- a final Consultancy Agreement was signed on 6 May 1998 by the Treasurer and KPMG Corporate Finance (Vic) Pty Ltd.

2.4.5 Actuarial Adviser

Three proposals were received from actuaries.[31]

The steps in the evaluation process for selecting an actuarial adviser were as follows:

- the ERSU review team assessed all proposals as being in Category 1.
- by Minute dated 7 April 1998 to the Selection Panel[32] the ERSU recommended the appointment of Mercers as the Actuarial Adviser.
- the Chief Executive, Department of the Premier and Cabinet and the Under Treasurer approved the appointment of Mercers on 7 April 1998 and the Crown Solicitor approved the appointment on 8 April 1998.

2.4.6 Communications Adviser

Ten communications consultants submitted Expressions of Interest or responses to the RFP.[33] The ERSU schedule indicates that two of the responses were received after the time specified for receipt of proposals (5.00 pm 27 February 1998).[34] As none of the proposals from the communications consultants who responded to the RFP were considered satisfactory, the role was separated between high level strategic communications advice and specialist support services.[35] A further search for communications consultants was instituted.

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30 This was confirmed by the Chief Commercial Counsel at a conference between Audit and the ERSU on 6 July 2000.

31 'Consultants' Schedule' to Minute to Consultant Selection Panel — 'Initial Report — Shortlisting of Lead Sale Adviser' dated 4 March 1998.

32 The selection panel comprised the Chief Executive, Department of the Premier and Cabinet, the Under Treasurer and the Crown Solicitor.

33 ERSU schedule listing receipt of proposals identifies ten proposals as 'Comm', 'Comm Advisor', 'Communications' or 'PR'.

34 ERSU schedule listing receipt of proposals shows No 75 made a 'Request for extension' and that No 122 was received at 8.00 am 2 March.

35 Minutes of Asset Sales Cabinet Committee Meeting on 7 May 1998.

The steps in the evaluation process for selecting a communication adviser were as follows:

- The successful Lead Adviser (Morgan Stanley/Pacific Road) was instructed on or before 23 March 1998 to conduct a search for a 'strategic' Communications Adviser.[36] Audit has not sighted any written instructions and the ERSU is not aware whether they were given in writing or orally.[37]

- A number of communications and public relations firms submitted proposals to either the Premier or the Lead Advisers in the period 20-24 April 1998.

- The Under Treasurer and an advisory team met with BDCN representatives on 28 April 1998.[38]

- The Lead Advisers wrote to the Under Treasurer on 29 April 1998 indicating that Walmarringin Pty Ltd (the company trading as BDCN) was their preferred consultant.[39]

- A Consultancy Agreement with Walmarringin Pty Ltd was entered into on 12 May 1998.

- A paper tabled in the Asset Sales Cabinet Committee meeting on 14 May 1998 included BDCN in the 'full team of consultants' which 'commenced work in Adelaide on 27 April 1998.[40]

- The Asset Sales Cabinet Committee decided on the appointment of a number of further specialist communications advisers at its meeting on 5 June 1998.

2.4.7 Economic Adviser

The steps in the evaluation process for selecting an economic adviser were as follows:

- A review team made up of senior officers from the ERSU conducted an initial evaluation of all proposals from consultants offering economic services by 3 March 1998.[41] The review team recommended that more information on the specific work to be performed be provided to four firms and they be asked to submit more detailed proposals. A letter in these terms was sent to the four firms on 10 March 1998, requesting more detailed proposals be submitted by 12 March 1998.[42]

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36 Morgan Stanley/Pacific Road facsimile letter of 24 March 1998 to the Under Treasurer.

37 Meeting with the Executive Director on 6 July 2000.

38 BDCN facsimile letter of 29 April 1998 to the Under Treasurer.

39 Morgan Stanley/Pacific Road facsimile of 29 April 1998.

40 ERSU paper titled 'Overview of Advisory Process'.

41 Internal ERSU Memorandum dated 3 March 1998 from one of the ERSU review team to the Chief Executive ERSU discussing the result of the review.

42 These are the dates of the letter to PHB and PHB's response.

- A selection panel was formed to evaluate the proposals and 'short-list' the preferred consultants.[43] The Selection Panel considered the four firms were suitable for inclusion in a short-list. Each of the four short-listed firms provided supplementary proposals as requested by the letter of 10 March and these, along with the original submissions, were assessed by the Selection Panel. The Panel reassessed the proposals of the four short-listed firms and decided to invite two for further interview. The interviews occurred in April 1998.

- The Selection Panel made a recommendation to the Asset Sales Cabinet Committee (through the Treasurer) by Minute dated 22 April 1998.

- Putnam Hayes and Bartlett (PHB) was informed it was the successful firm in late April 1998.[44]

- The Consultancy Agreement is dated 6 May 1998. The ERSU documentation indicates, however, that PHB commenced performing services before 6 May 1998.

2.4.8 Engineering Advisers

The steps in the evaluation process for selecting an engineering adviser were as follows:

- A review team, made up of senior officers from the ERSU conducted an initial evaluation of all proposals from firms offering engineering services by 3 March 1998.[45] The review team assessed two firms as Category 1 and two as Category 2.[46]

- A selection panel[47] was formed to assess the engineering proposals. The Selection Panel conducted a further assessment of the proposals and decided that further information was required. A Request for Additional Information was forwarded to four consultants on 7 May 1998. All four consultants responded by 13 May 1998.[48]

- On 14 May the Selection Panel agreed that interviews should proceed with two short-listed engineering advisers, and they were interviewed by the Selection Panel on Friday, 15 May 1998.

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43 The selection panel comprised the Executive Director, Market and Regulatory Reform, ERSU (Chair) and another ERSU officer; another ERSU officer assisted in the process. Minutes forming Enclosure to Asset Sales Cabinet Committee Selection of Economic Consultants, dated 22 April 1998.

44 The letter from PHB Inc to the Treasurer re self insurance is dated 24 April and refers to the negotiation of the Consultancy Agreement.

45 Internal ERSU Memorandum to the Chief Executive ERSU and Under Treasurer, 'Re: Engineering Consultants', dated 3 March, 1998.

46 ERSU Assessment Table, 'Engineers (Sorted Alphabetically)', dated '6/03/98'.

47 The selection panel comprised the Strategic Industry Advisor, ERSU (chair); another ERSU officer; a representative of Pacific Road Corporate Finance (Lead Adviser) and a representative of Putnam Hayes Bartlett (Economic Adviser), ERSU Minute dated 21 May 1998 to the Treasurer.

48 Internal ERSU memorandum dated 13 May 1998.

- The Selection Panel made a recommendation to the Treasurer by Minute dated 21 May 1998.

- The Treasurer informed the Asset Sales Cabinet Committee by Minute dated on 4 June 1998[49] that he had approved the selection of Sinclair Knight & Merz (SKM) and Burns and Roe Worley (B&RW) as engineering advisers with respect to separate aspects of the disposal process.

- Draft consultancy agreements were sent to the selected engineering advisers on 13 June 1998.[50]

- Both the SKM and B&RW Agreements are undated. However, the B&RW Agreement has a specified commencement date of 25 May 1998 and the SKM Agreement has a specified commencement date of 5 June 1998. The ERSU have advised that the SKM and B&RW consultancy agreements were executed by the Treasurer on 14 October 1998 and 13 January 1999 respectively.[51]

2.4.9 Environmental Consultants

The steps in the evaluation process for selecting environmental consultants were as follows:

- A review team made up of senior officers from the ERSU conducted an initial evaluation of all proposals from firms offering environmental services by 6 March 1998.[52] Two distinct environmental consultancies were identified: a primary consultant to advise on due diligence and plant assessment issues related to the disposal, and a consultant to provide policy advice in relation to environmental outcomes from the market and licence arrangements.[53] The review team recommended that two environmental firms be short-listed for interview for the primary consultant role and one firm be further investigated for the role of policy adviser.[54]

- On 13 May the Selection Panel[55] agreed that interviews should proceed with the consultants recommended by the review team. The Selection Panel met with the short-listed consultants on 14, 15 and 19 May 1998. At the interview and

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49 By a covering Minute dated 4 June 1998 ERSU provided a draft Minute to the Asset Sales Cabinet Committee for the Treasurer's signature. This draft Minute was also copied to the Asset Sales Steering Committee.

50 Letter from ERSU to Auditor-General dated 21 July 2000.

51 ibid.

52 Summary evaluation schedule, 'Environmental Proposals in Categories', dated '6/3/98'.

53 ERSU Minute dated 13 May 1998, Re: Short-listing of Environmental Consultants for Interview.

54 ibid.

55 The selection panel comprised the Strategic Industry Advisor, ERSU (chair); another ERSU officer; a representative of Finlaysons (Legal Adviser) and a representative of Putnam Hayes Bartlett (Economic Adviser), ERSU Minute dated 25 May 1998 to the Treasurer, 'Appointment of Environmental Advisers'.

subsequently, the firms had the opportunity to make further representations/ submissions on the issues the Government had identified at interview as being of concern to it.

- The Selection Panel made a recommendation to the Treasurer by Minute dated 25 May 1998.

- The Treasurer informed the Asset Sales Cabinet Committee by Minute dated on 4 June 1998 that he had approved the selection of Hyder Consulting and Energetics as environmental advisers.

- Both the Hyder Consulting and Energetics Consultancy Agreements are undated. However, both Agreements have a specified commencement date of 1 June 1998. The ERSU have advised that both contracts were executed after the commencement date.

2.4.10 Project Manager

The steps in the evaluation process for selecting the project manager were as follows:

- Thirteen submissions dealing with Project Management were received in response to the RFP.[56] Of the submissions reviewed, the ERSU review team considered the majority were too general and offered a diverse range of skills which were not targeted to the ERSU's needs.[57]

- On the basis of the ERSU review team assessment more information was requested from two proposers to assess their capability against the ERSU's needs. Interviews were also held with key staff of these two proposers.[58]

- The ERSU recommended the immediate appointment of Kinhill to the Under Treasurer on 18 March 1998 to provide project management services under detailed terms and conditions to be established.[59]

- The Under Treasurer approved the appointment on 20 March 1998.[60]

- The Consultancy Agreement is undated but the First Schedule specifies that the commencement date is 23 March 1998. The Consultancy Agreement was executed in June 1998.

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56 Internal ERSU Memorandum dated 18 March 1998, 'Subject: Project Management Support'.

57 ibid.

58 ibid.

59 ERSU Minute to the Under Treasurer dated 18 March 1998.

60 Handwritten note 'Approved GB 20/3' on the ERSU Minute to the Under Treasurer dated 18 March 1998.

PART 3
REQUEST FOR PROPOSAL (RFP)

This Part of the Report comments on the matters arising from the issue and receipt of the Request for Proposals.

3.1 TIMEFRAME FOR THE RFP

The advertisement seeking proposals for the key advisers was published on 18 February 1998 and stated that the closing date for receipt of proposals was 27 February 1998. The commencement date for key advisers was proposed as 9 March 1998.

Notwithstanding this, the Lead Advisers did not commence work until 8 April 1998 and the other advisers commenced at various times up to June 1998.

Audit Comment

The specified dates in the advertisement created a very short period for potential service providers to prepare and submit their proposals, and for the Government to assess all proposals, short-list and interview the 'most suitable' service providers, and negotiate contractual terms with the successful Advisers before they commenced work.

It is not unusual for government to work within short timeframes to achieve outcomes, however, a number of principles need to be considered when imposing such a timeframe:

- there must be a realistic assessment of the time required by interested parties to respond to a Request for Proposal;
- there must be a realistic assessment of the time required to evaluate those proposals;
- reduced timeframes should not be imposed unless there is an identified objective imperative to have the particular expertise available by a given date;
- where a process must produce an outcome within a short timeframe, the process must be well planned, and must be appropriate for, and capable of, meeting the timeframe.

In my opinion, it was never likely that such a process could be adequately carried out in the advertised timeframe.

Further, the short closing date for receipt of proposals did not comply with the Department of Treasury and Finance Guidelines for the Use of Consultants/Contractors which provides, inter alia, in Appendix 3, 'Procedures for the Engagement of Consultant Services', section 3 'Invitation for Consultant Proposals':

> *There are some standard procedures to be adopted irrespective of the method used. These include:*
>
> - *sufficient time must be given to all Consultants to submit a tender/proposal (at least three weeks);*

In their terms these Guidelines are mandatory[61] and the ERSU is, of course, part of the Department of Treasury and Finance.

I note the ERSU's argument that this process was not subject to the Guidelines. That argument is based on the following points:

- the Guidelines only cover consultancies up to $1 million;
- the process to engage advisers was undertaken under the supervision of the Treasurer and Cabinet who were not bound by the Guidelines;
- the failure of the Guidelines to address success fees and the inability of the ERSU to engage some of the advisers without agreeing to success fees indicates that the Guidelines should not be taken to apply, however, the ERSU suggest it may be appropriate to review the Guidelines to provide for consultancies that use success fees.

The suggestion that the Guidelines cover consultancies up to $1 million comes from the fact that the Treasurer had the appropriate delegation in respect of Department of Finance and Treasury matters to approve expenditure up to $1 million. It seems to me somewhat unusual to propose that fairly rigorous Guidelines apply where less than $1 million is being spent but as more money is being expended, those conducting the process are not subjected to the same rigour.

I accept that the Treasurer was the ultimate decision-maker as to which advisers were engaged. However, it would be reasonable to expect Department of Treasury and Finance officials to comply with usual Departmental procedures when conducting a process, even where the Treasurer was the decision-maker. To do otherwise is to expect the Treasurer to direct 'the process' to be followed in reaching the outcome, not just the 'outcome'. I have seen no evidence that the Treasurer directed the ERSU to ignore their usual Departmental administrative practices and to follow an alternative process.

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[61] Department of Treasury and Finance Guidelines for the Use of Consultants/Contractors, state at p 4, 'Note: These Guidelines must be adhered to …'.

For these reasons I have continued to refer to the Guidelines throughout this Report as relevant. I consider that it was reasonable to expect the ERSU to follow the Departmental administrative procedures dictated by the Guidelines in carrying out a process, even where the Treasurer was the ultimate decision-maker.

Although it is a matter for government to specify the timeframe for a particular process, to maintain credibility in government procurement processes, it is my opinion that it is better to publish and adhere to realistic timeframes.

The fact that the RFP gave such a relatively short period to lodge a proposal (eight working days in the period 18 to 27 February 1998 inclusive) may well have discouraged some potential proponents. In addition, it is possible that some entities treated the indicative start date of 9 March 1998 as firm and did not bid because their circumstances were such they could not meet this start date. These potential proponents might have bid had they appreciated that realistic start dates for key consultants were actually mid to late April, May and June 1998.

Audit does note, however, whether or not other potential proponents existed who did not lodge a proposal is speculative and that a significant number of proposals were received.[62]

Audit Recommendation 1

In planning processes to select consultants, I recommend consideration be given to whether the process to be used is capable of meeting the advertised deadline which must be a reasonable deadline in the circumstances.

3.2 INCLUSION OF INFORMATION IN A RFP

In relation to the contract negotiations, I am of the opinion that the risk of lengthy contract negotiations would have been reduced by inclusion in the RFP of a complete set of terms and conditions for the contract to be entered into by the Treasurer and the Advisers. This would have drawn out from each proposer the areas requiring negotiation. If, in such circumstances, a consortium had responded with the statement similar to that submitted by the ultimately successful Lead Adviser consortium. ie: 'The organisations confirm that there are **no areas within the State's standard terms and conditions** of contract with which they are unable to comply.'[63] [emphasis added], then a contract could have been executed with that consortium immediately.[64]

62 Refer to discussion earlier in this Report under the heading '2.3 — Receipt of Proposals'.

63 Paragraph 9 of the consortium's proposal dated 27 February 1998.

64 Department of Treasury and Finance Guidelines for the Use of Consultants/Contractors, Appendix 1 'Consultant or Contractor Engagement Methods' section 4 'Request for Proposal Process' which recommends key contractual terms be stipulated.

Where processes are used that require the negotiation of a formal agreement from a statement of principles without detailed format, and one party has indicated they are under a time imperative to settle the agreement, there is a risk that the bargaining position of that party will be compromised and they may find themselves under pressure to compromise on terms and conditions. While I am not suggesting this did occur in relation to any of the Advisers, I consider it worthwhile to take measures to reduce the potential risk.

Refer to further commentary on this matter under the heading '6.4 — Indemnity' in this Report.

Audit Recommendation 2

I recommend that RFP documentation provide information on all matters likely to significantly impact on submissions, including, the key terms and conditions for any resulting contract.

PART 4
PRE-SUBMISSION DISCUSSION

4.1 PRE-SUBMISSION DISCUSSION WITH ONE POTENTIAL SERVICE PROVIDER

The documentation reviewed by Audit indicated that the Steering Committee[65] met with one proposer a few days before proposals were due for lodgement. The Consortium presented its credentials to the Steering Committee at the meeting. The meeting was held even though requests for meetings were refused with other potential proposers in the period up to lodgement of proposals. The ERSU later observed that:[66]

> *The meeting offered (the consortium) a potential advantage over other consultants — requests for meetings were refused with other potential lead consultants in the period up to lodgement of proposals. The meeting was arranged on the understanding that (the consortium) wished to act on the buy side (rather than as a contender for the lead advisory role) and therefore would provide useful information about interest in South Australia's assets.*

The proposer in question submitted a proposal, which was evaluated but was not short-listed.

Audit Comment

Contact with potential proposers during a selection process must be managed so that no potential proposer is unduly prejudiced as a result and so as to avoid the implication or perception of bias. This is not to say that contact cannot occur, but the implications of, and rules concerning, contact must be clearly communicated to those seeking it.

Following the handing down of the 'Report of the Auditor-General — Part 3 — SA Water Corporation' in 1996, the Department of Treasury and Finance Guidelines for the Use of Consultants/Contractors were amended to address the RFP process, with an emphasis on the need for the process to be fair and equitable and comply with the highest degree of probity. The Government Management Board Guideline No 5 'Engagement and Use of

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65 The ERSU officers advised in a conference on 6 April 2000 that it is likely that the reference to the Steering Committee is a reference to the Selection Panel which was also called the Steering Committee from time-to-time.

66 Minute to the Chief Executive, Department of the Premier and Cabinet dated 17 March 1998.

External Consultants'[67] also emphasises that a consultancy selection process must be conducted with probity and fairness to bidders.[68]

Audit notes that this pre-submission discussion with only one potential service provider is not consistent with the Department of Treasury and Finance Guidelines for the Use of Consultants/Contractors which provides, inter alia, in Appendix 3, 'Procedures for the Engagement of Consultant Services', section 3 'Invitation for Consultant Proposals':

> *Prior to the closing date, the Project Manager should discuss the assignment with each Consultant to ensure that they all understand the requirements of the assignment. If during this time it becomes apparent that further information is needed or an explanation of one or more aspects of the brief is required, an addendum to the brief should be prepared and issued to each Consultant.* **The Project Manager is responsible for ensuring that each Consultant is provided with the same information so that they are all able to prepare their proposals on the same basis.** [emphasis added]

In the circumstances, I consider that holding this meeting was neither fair nor equitable and in fact constituted a breach of probity. As the ERSU itself recognised,[69] the consortium had been given a potential advantage over other bidders by being granted the meeting.

The ERSU has advised[70] that the meeting was not considered to be with a potential proposer because the ERSU were not aware that the consortium would submit a proposal until after the meeting. Notwithstanding this situation the ERSU evaluated the proposal that was lodged. In this regard the ERSU states:

> *… the proposal was considered to ascertain its substance. If on assessment the proposal had been shown to be of substance such that ordinarily it would have warranted consideration, then the fact that a meeting had taken place would have had to have been considered.*

In my opinion, the request for the meeting should have been considered on the basis of whether or not the consortium was a potential proposer. If, as later stated, the meeting was requested on the understanding that the consortium wished to act on the 'buy side' rather than in the lead advisory role, the consortium should have been advised that if the meeting went ahead it would be on the basis that a proposal from the consortium was not expected and if lodged would not be considered.

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67 This guideline is intended to assist agencies in seeking, selecting, managing and evaluating external consultants.

68 'The principal concern is to obtain best value for money whilst maintaining full probity and equality of competitive opportunity for bidders.' Section 4 'Selecting the Consultant'.

69 Minute to the Chief Executive, Department of the Premier and Cabinet dated 17 March 1998.

70 Letter dated 31 August 2000 from the Under Treasurer covering the ERSU response to issues raised by Audit.

I do recognise that it is not feasible to cease contact with all parties during an RFP process, especially where parties may be seeking or providing information in respect of the broader disposal process. Care must be taken, however, to ensure that such contact does not provide a participant in the RFP process with an advantage over other participants. The difficulties in this context can be overcome by the adoption of protocols ***before*** the commencement of the selection processes.

Audit Recommendation 3

I recommend that as part of the planning process for the conduct of an RFP, protocols be drawn up to govern contact with potential bidders during an RFP process.

PART 5
EVALUATION OF RESPONSES TO REQUEST FOR PROPOSALS (RFP)

This Part of the Report comments on matters relating to the evaluation of the responses to the Request for Proposals.

5.1 LATE SUBMISSION OF PROPOSALS AND MATERIAL

The ERSU schedule recording the receipt of proposals shows that a number of proposals were received from proposers after the cut-off time specified in the RFP. Discussion with the ERSU officers has confirmed that any proposal that was received after 5.00 pm on 27 February 1998 or on any subsequent days was accepted and evaluated. The ERSU states that this was in accordance with the reserved right to accept late proposals in its facsimile to potential proposers on 24 February 1998.[71]

In addition, some proposals were deficient in addressing the requirements of the RFP, and supplementary material was submitted after 5.00 pm 27 February 1998 to address this deficiency. For example, the proposal submitted by one proposer omitted details of relevant industry experience, yet this was a key factor identified in the RFP. Details of the relevant industry experience were provided approximately three days later.

In another example, the proposal put forward by a consortium included only seven lines in respect of the expertise that one of the firms would bring to the consortium. A further 14 page document was subsequently received over a month later to address the initial deficiency in information.

This material was accepted and evaluated by the ERSU. When asked whether there was any consideration of the propriety of accepting the late material, the ERSU responded that: 'The decision to accept them was at the discretion of the Under Treasurer'.[72]

Audit Comment

Neither the terms of the RFP, nor the facsimile of 24 February 1998, detail how late submissions were to be considered. The Department of Treasury and Finance Guidelines for the Use of Consultants/Contractors provide little guidance.[73]

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71 Letter dated 31 August 2000 from the Under Treasurer covering the ERSU response to issues raised by Audit.

72 Letter dated 31 August 2000 from the Under Treasurer covering the ERSU response to issues raised by Audit.

73 Appendix 3, 'Procedures for the Engagement of Consultant Services' of the Department of Treasury and Finance Guidelines provides in section 3. 'Invitation for Consultant Proposals' only that 'Acceptance of late tenders must be approved by the CEO'. In this respect the Guidelines reflect Treasurer's Instruction 308.4 'Late tenders shall be indicated as such on the Form 22 and shall only be admitted for consideration with the approval of the Chief Executive Officer'.

In the 'Report of the Auditor-General — Part 3 — SA Water Corporation' in 1996 I recommended the establishment of publicly promulgated guidelines to assist agencies that are required by government to develop contractual relationships where the procedure involves a RFP process. Following the tabling of that Report I note that the 'Department of Treasury and Finance Guidelines for the Use of Consultants/Contractors' were amended to address the RFP process, with an emphasis on the need for the process to be fair and equitable and comply with the highest degree of probity.

I also note that the Federal Acquisition Regulations (FARs) administered by the US Government Services Administration Board provide clear direction to officials dealing with late proposals under a RFP process. In the 'Report of the Auditor-General — Part 3 — SA Water Corporation' in 1996, I made the following comments at page 19:

> *The FARs — are a source of accepted rules of engagement. Many of these rules may not be applicable or appropriate in the South Australian environment. They are, however, a useful and appropriate guide for the preparation of accepted rules of engagement for, and conduct of, an RFP process in this State.*

The ERSU has confirmed that all proposals received after 5.00 pm on 27 February 1998 were considered and evaluated. In taking the administrative decision to accept proposals received 'late' on 27 February 1998 the officers of the ERSU were clearly cognisant that this was a RFP, rather than a Request for Tender (RFT), process. The distinctions between a RFP and a RFT process were fully discussed in the 'Report of the Auditor-General — Part 3 — SA Water Corporation' in 1996, in particular in Appendix E, Advice from the Solicitor-General to the Auditor-General dated 17 December 1995.

No formal legal or other advice was sought as to the implications of admission of the late proposals to evaluation, ie whether it afforded the proposers in question an advantage over other proposers, or whether any of the late proposals should have been excluded from further consideration. Although the facsimile to potential proposers reserved the right to accept late proposals, any consideration as to whether or not the right should be exercised was not documented.

I am concerned that, although there is no evidence of any substantive unfairness to any of the potential advisers by the admission to evaluation of the late proposals, there can be a perception of unfairness in their admission. Further, I am concerned that the consideration of the legal and equitable implications of exercising the reserved right to accept late proposals was not documented.

I note that, since this issue was raised by Audit, the Crown Law Office has provided a legal opinion that no advantage did accrue to any proposer from the late submission of bids or material.[74]

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[74] Crown Law Report dated 22 August 2000.

I am concerned that acceptance and evaluation of late proposals or material has been a significant issue in both the SA Water Corporation RFP process and in the RFP process for the engagement of Advisers for the electricity businesses disposal process. I am of the opinion that the formulation of appropriate rules of engagement for officers dealing with late proposals or material under a RFP process is appropriate. Such rules of engagement, if properly applied, would obviate issues of procedural fairness arising in respect of late proposals or material.

Audit Recommendation 4

I recommend the establishment of promulgated guidelines to assist agencies required to develop contractual relationships involving an RFP process.

Further, I recommend that a statement be included as a standard term of all procurement process documents as to whether, and in what circumstances, a late proposal or late material will be considered.

Where a late proposal or late material is received, I recommend that any decision to admit or not admit that material to the evaluation be documented.

5.2 SELECTION CRITERIA

In my opinion, it is important in conducting government procurement processes to ensure that the selection criteria used to evaluate submissions are consistent with the terms of the process notified to participants, in this case through the RFP document.

Further, the Department of Treasury and Finance Guidelines for the Use of Consultants/Contractors stipulate that a standard set of evaluation criteria is to be developed prior to the proposal closing date and that a detailed evaluation of each proposal is to be undertaken based on the agreed criteria.[75] The ERSU has advised that the selection criteria set out by the review team as the criteria against which proposals were initially evaluated were developed prior to the proposal closing date.[76]

Audit Comment

In reviewing the evaluation of the proposals against identified criteria, Audit noted that the criteria do not refer to conflicts of interest, which was an area on which proposers (quite

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[75] Appendix 3 'Procedures for the Engagement of Consultant's Services', section 4 'Selection Process' of the Guidelines.

[76] Minute to Consultant Selection Panel 'Initial Report — Shortlisting of Lead Sale Adviser' dated 4 March 1998.

correctly) were asked by the RFP to respond. I note, however, that potential conflicts were considered, notwithstanding that they had not been identified as a selection criterion.[77]

On the other hand, local South Australian content, which is one of the selection criterion set out by the review team, was not referred to in the RFP as being a consideration, and therefore, proposers were not initially asked to respond in relation to this aspect. For example, Audit noted that, in respect of a particular proposal that the ERSU review team had assessed, there is a comment that that the proposer 'would need to nominate a local firm from our category 1 or 2'.

Audit Recommendation 5

I recommend that the selection criteria to be applied for any government procurement process be identified, documented, and communicated to potential proposers through the procurement process documents.

5.3 ASSESSMENT METHODOLOGY

The 'Department of Treasury and Finance Guidelines for the Use of Consultants/ Contractors' states in Appendix 4, 'Contents of Detailed Specifications or Consultant Brief and Evaluation Criteria', section 3, 'Criteria for Evaluation of Proposals' that:

> *The selection process should involve both quantitative and qualitative analysis of bids. It is therefore useful to develop a spreadsheet points score approach to short-list consultants initially, prior to seeking further information or conducting a detailed analysis of those bids …*
>
> *While it is obvious that the weighting given to each [criteria] will vary from project to project, an allocation of percentage points which could be a useful guide is set as follows:*
>
> - *project understanding and proposed solution* *30%*
> - *qualifications, experience and demonstrated capabilities* *20%*
> - *details of project-related site references* *15%*
> - *availability of key consultancy staff, the proposed time scale* *10%*
> - *basis of the proposed fees and charges* *20%*
> - *other issues such as skills transfer* *5%*

[77] 'Conflicts with other Austn govts/asset reforms and sale' is an assessment criteria in the summary table document 'Lead Advisors Proposals in Categories (Sorted Alphabetically)' dated 4 March 1998 which is attached to Minute to Consultant Selection Panel 'Initial Report — Shortlisting of Lead Sale Adviser' dated 4 March 1998.

Audit Comment

I note that in respect of the appointment of Advisers to the Disposal Process, neither the various ERSU review teams, nor the Selection Panel, gave quantitative weighting to selection criteria.

I consider that the selection criteria for the consultancies examined in this Report should have been subject to both quantitative and qualitative assessment to ensure transparency and provide a clear audit trail of the selection process. Without such quantitative weighting of criteria the reasons why one proposer was chosen over another may not be clear and therefore open to challenge.

For example, with respect to one adviser group, the Selection Panel assessed two proposals against 'Resource Commitment', 'Advisory Experience' and 'Local Content' with factual comments made against these criteria but no quantitative weighting. The Selection Panel then arrived at a conclusion with no reference back to the assessment criteria, notwithstanding that one proposal had no 'Local Content'.

Quantitative weighting would have ensured that the selection process was a readily referenced process with an objectively verifiable result.

Audit Recommendation 6

I recommend that in future consultancies selection criteria be subject to quantitative as well as qualitative assessment.

5.4 REQUESTING AND CHECKING OF BONA FIDES AND REFERENCES

The RFP asked proposers to supply the names of five referees who would be able to comment on the performance of both the firm and the individuals being proposed. Apart from this, the RFP did not require proposers to provide any other information concerning the general bona fides of the firm or its key personnel.

During evaluation of the proposals, the referees were contacted by telephone. There is no evidence of any other checks undertaken by the ERSU of the general bona fides of the short-listed firms for the lead advisory role and their key personnel.

It is relevant to note that, following a report in The Australian Financial Review on 15 April 1998 (day of contract signature) the successful Lead Advisers confirmed to the Treasurer and Under Treasurer that their parent company had been fined by the NASD[78] (United

[78] National Association of Security Dealers.

States regulator of technology stocks index) for manipulating the opening prices of 10 component stocks in the Nasdaq 100 Index[79] in October 1995. As reported in that article, the parent company of one of the entities in the Lead Advisers consortium had been discussing the charges with the NASD for some 16 months.

Audit Comment

In my opinion, the knowledge and consideration of such information is critical to the assessment of the proposers' ability to undertake the project. The risk of disclosure of such a matter so late in the process could have been minimised if the RFP had sought information from proposers as to matters that had the potential to impact upon the proposer's reputation or financial viability. This is particularly the case in RFP processes seeking to engage a consultant for a role integral to the success of a significant project, which is the case in respect of the lead advisory role for the disposal process.

Audit Recommendation 7

I recommend that any RFP require proposers to provide information as to any current litigation, investigations, charges etc in which they or their company, their parent company or subsidiaries are involved.

Further, I recommend that a verification of the bona fides of proposers form part of the evaluation process in any RFP process for the selection of a consultant for a significant role in a project of public importance.

[79] The NASDAQ 100 Index is composed of 100 of the largest and most actively traded non-financial companies listed on the National Association of Security Dealers Automated Quotation Stock Market.

PART 6
CONTRACT FORMATION

This Part of the Report considers a number of matters related to the formation of the Consultancy Agreements between the Treasurer and the Advisers.

6.1 TIMEFRAME FOR THE SELECTION OF THE ACCOUNTING ADVISER

The process for the selection of the Accounting Advisers was as follows:

- The short-listing of potential Accounting Advisers occurred on 14 April 1998;
- The short-listed firms were interviewed on 15 and 16 April 1998;
- The Asset Sales Cabinet Committee approved the selection of successful Accounting Adviser on 22 April 1998;
- A draft Consultancy Agreement was passed to that firm on 23 April 1998;
- The Consultancy Agreement was executed on 30 April 1998;
- The Accounting Adviser commenced delivering services on 30 April 1998.
- The Treasurer executed the contract on 6 May 1998.

Audit Comment

Although six weeks elapsed between the closing date for responses to the RFP and the short-listing of potential advisers, the process of selecting the Accounting Adviser and negotiating and finalising contractual arrangements occurred in a much more compressed period (two weeks). This latter period was a time of significant activity for the Government when a number of other consultancy arrangements were going through a similar selection process (eg Legal Advisers, Economic Adviser etc).

Although there were pressures to expedite the finalisation of the Accounting Adviser consultancy (and other consultancies), this was a highly significant consultancy both in terms of its importance to the disposal process and the potential financial outlay by the State. I have concerns as to whether the pressure of time led to the selection of the Accounting Adviser and the negotiation of the consequential contractual terms being a less than fully considered process, such that the State's bargaining position and hence the State's interests in striking the 'best' commercial deal were compromised.

In this respect I note that the documentation supporting the finalisation of the arrangement indicates that a number of changes to the Consultancy Agreement proposed by the Accounting Adviser dealing with the success fee, insurance, termination etc (which were to the benefit of the Adviser by shifting risk exposure to the State) were all agreed to by the Government. There was, however, no documentary evidence of the consideration of the risks/benefits of the Government's acceptance of these matters.[80]

Where significant contractual terms are being negotiated in a consultancy of such a magnitude it is important that a clear audit trail is established to record the reasons why concessions were made, particularly having regard to the potential precedent created.

In making these comments, I am not suggesting that a procurement process needs to be subject to rigid deadlines, but rather that any deadlines must be realistic and appropriate to the circumstances to ensure the decision making process is not rushed and is fully documented.

Audit Recommendation 8

I recommend that procurement processes be structured to allow for the full consideration of all relevant issues and to avoid self-imposed pressures (eg time) that confer potential bargaining strength in negotiations to the other party.

Audit Recommendation 9

I recommend that where concessions are made in contract negotiations the reasons for making those concessions (including an assessment of the benefits obtained) be clearly documented.

6.2 DEFINITION OF SERVICES

A specification or consultancy brief serves as both a planning and control mechanism for a project and a prescription for results (outcomes or outputs) to be achieved by the consultant. The specification, in the last resort, is also the document protecting the Government's legal rights.

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80 The Chief Counsel Commercial advised, at a conference with Audit on 6 July 2000 that he prepared the draft contract and discussed with the ERSU and the Treasurer whether or not certain risk implications of amendments would be acceptable. Risk assessment was not formally documented.

The 'Department of Treasury and Finance Guidelines for the Use of Consultants/Contractors' states, inter alia, in Appendix 4 'Contents of Detailed Specifications or Consultant Brief and Evaluation Criteria':

> *The points below outline the areas which should be included in a detailed specifications or brief for a consultancy.*
>
> - *The main objectives of the project must be clearly stated. Any overriding or limiting considerations or general policy should be mentioned and problems to be solved should be identified and described;*
> - *Specific matters to be encompassed (or not encompassed) or specific fields to be studied (or not studied) should be stated;*
> - *As far as possible the specific tasks that the Consultant is required to undertake should be listed in logical and/or time sequence. Where appropriate, and particularly for larger projects, this should extend to the identification of the phases (and the associated progress review points) into which the project is intended to be divided;*

These matters should be addressed comprehensively in the Consultancy Agreement, particularly having regard to:

- the importance of the role of the Advisers for the Project and the fees involved;
- minimising the possibility of disputes. As a general proposition the more generally or loosely consultancy services are defined the more scope the parties have to subjectively interpret what is required under the contract and consequently, the more scope there is for dispute;
- consistency of contract management between the different advisers.

The following commentary provides a summary of the contracted services specifications that, in my opinion, could have been improved.

Lead Advisers

The third Schedule of the Lead Advisers' Consultancy Agreement sets out the services to be provided as follows:

Part 1 sets out the kinds of services required. The list is generic in nature.

Part 2 sets out the desired outcomes for each stage. The outcomes for Stage 1 (scoping stage) run to some two pages and are reasonably detailed. However, the desired outcome for Stage 2 is 'the blueprint adopted by the Government for the restructure of the South Australian Electricity Industry and for Stage 3 that 'the Government's electricity assets are sold for the best price that can reasonably be obtained for them in the circumstances of the restricted industry and the then existing market'.

See below under 'Audit Comment' for details of deficiencies in the Lead Adviser's contract regarding services to be delivered.

Economic Adviser

Clause 5 of the Consultancy Agreement (Services) provides:

> *The service to be provided by the Consultant under this Agreement is the delivery of economic advice to the Client and the Client's Advisers in respect of issues relating to the Project as and when the Client requires.*

There is no Services Specification attached as an annexure to the Agreement as with a number of the other Consultancy Agreements (including the Consultancy Agreement for the Accounting Adviser, who was also tasked with providing 'strategic advice on economic issues'[81]). The Services offered by the Economic Adviser were detailed in its response to the RFP, and in its 13 page supplementary proposal of 12 March 1998. Neither that response nor the supplementary proposal form part of the contract.

Environmental Consultants

Clause 1.15 of the Consultancy Agreement with one of the two environmental consultants defines 'the Services' as:

> *… those environmental services the Consultant must perform in relation to greenhouse policy objectives and demand-side strategies for the Project as specified in the Annexure and as required by the Client in writing from time to time.*

There is, however, nothing attached as an Annexure.

Clause 1.15 of the Consultancy Agreement with the other environmental consultant defines 'the Services' as: 'Those services the Consultant must perform as specified in the Annexure and as required by the Client in writing from time to time'.

The Annexure consists of a 'Letter of Appointment' dated 2 June 1998 from the ERSU to the Manager Environmental Services. The Letter of Appointment only has a very cursory description of the services to be provided; it states, inter alia:

> *In broad terms, … will be responsible for:*
>
> - *undertaking an environmental due diligence review of all the assets for sale*
> - *reviewing options (in consultation with other consultants) for reconfiguring plant in terms of environmental issues*

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81 Minutes forming Enclosure to Asset Sales Sub Committee of Cabinet Selection of Economic Consultants, dated 22 April 1998.

- *providing this information to the due diligence data room*
- *input to the scoping Study where environmental issues may impact on issues such as structure or value.*

From time to time more detailed work briefs may be submitted by ERSU …

The Letter of Appointment does refer to the Consultant's 'proposals dated 26 February 1998 and 11 May 1998', but those proposals are not attached to the Agreement.

Audit Comment

In my opinion, the third Schedule of the Lead Advisers' Consultancy Agreement is deficient in defining the services the Lead Advisers are to deliver with respect to Stages 2 and 3 of the Project. The development of a comprehensive Services Specification is a performance monitoring and contract management requirement that represents good administrative practice.

The ERSU has advised that:

> *In relation to the quality of services provided by [the Lead Advisers] this was certified through the achievement of milestones described in the contract and from the input of [the Lead Advisers] personnel in the issues being dealt with by ERSU.*[82]

In my opinion, however, this statement is inconsistent with the fact that the contract does not describe any milestones for Stages 2 and 3 of the Project.

The Services to be provided under the Economic and Environmental Adviser Consultancy Agreements are in essence undefined. The formula incorporated in the contracts were intended to (and do) confer complete discretion on the Government and thus ensure flexibility. Nevertheless, I consider that flexibility could have been achieved along with certainty and transparency if a more detailed scope of work or Services Specification had been developed and annexed to the Agreements.

The failure to draw up a comprehensive Services Specification and annex it to the Consultancy Agreements does not, in my opinion, represent good administrative practice.

Audit Recommendation 10

I recommend that in contracts for advisory services, the services to be performed and outcomes to be achieved be fully described.

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[82] ERSU letter of 22 March 2000 to the Deputy Auditor-General.

6.3 CONTRACT TERMS DEALING WITH CONFLICTS OF INTEREST

6.3.1 Overview

An important part of any contractual arrangement must be the management of issues dealing with conflicts of interest. The following commentary provides an overview of the arrangements in place with the Advisers for the disposal process, together with Audit comments.

Lead Adviser

Under the Consultancy Agreement with the Lead Advisers the Treasurer may terminate the Agreement by notice in writing if the Lead Advisers have an actual conflict of interest in relation to the Agreement.

The Treasurer may not, however, terminate the Agreement unless he first:

- allows the Lead Adviser a reasonable opportunity to propose to the Treasurer a course of action for the removal of the conflict;
- endeavours, in good faith to negotiate with the Consultant a resolution of the conflict.

Legal and Accounting Advisers

The Consultancy Agreements with the Legal and Accounting Advisers provide that:

> *The Client may terminate this Agreement immediately by notice to the Consultant if it comes to the Client's attention from whatever source that the Consultant is in an actual and material conflict of interest in relation to this Agreement.*

The Agreements also provide that:

> *The Consultant must disclose to the Client in writing, all actual and potential material conflicts of interest that exist, arise or may arise (either for the Consultant or the Consultant's Team) in the course of performing the Services as soon as practical after it becomes aware of that conflict.*

The Legal Adviser Agreement also provides that with the prior written consent of the Client (not to be unreasonably withheld) any of the firms constituting the Consultant may act for financiers for potential and actual bidders for the electricity assets. The grounds on which it would be justified for the Client to withhold its consent are set out in the paragraph:

> *(i) the acceptance of an engagement by the relevant firm would place it in a position of actual or potential and material conflict;*

(ii) the relevant firm has been unable to secure the execution by the financiers of a release in favour of the firm to the effect that the firm is not required to provide to the financiers any information or advice deriving from the firm's engagement by the Client under this Agreement; and

(iii) the Client has not received a reasonably satisfactory assurance from the relevant firm that the acceptance by the firm of the engagement by the financier will in no way affect the liability of the Consultant to the Client under this Agreement (including liability of the Consultant arising in relation to any conflict which subsequently occurs).

Other Advisers

The Consultancy Agreements with the Actuarial, Communications, Economic, Engineering, Environmental, and Project Manager Advisers provide that:

> *The Client may terminate this Agreement immediately by notice to the Consultant if it comes to the Client's attention from whatever source that the Consultant is in an actual conflict of interest in relation to this Agreement.*

The Consultancy Agreements also provide that:

> *The Consultant must disclose to the Client in writing, all actual and potential material conflicts of interest that exist, arise or may arise (either for the Consultant or the Consultant's Team) in the course of performing the Services as soon as practical after it becomes aware of that conflict.*

Audit Comment

The following commentary relates to issues arising from the above contract arrangements.

6.3.2 Resolution of Perceived Conflicts of Interest

With respect to each of the Agreements the ability to terminate the Agreement only applies to an 'actual' conflict of interest, and not to a perception of a conflict of interest. As I have noted in a previous Report, however, 'The perception that a conflict of interest exists can be as damaging to the disposal process as an actual conflict'.[83]

The reference to a 'potential or actual conflict' in the disclosure clauses of the Agreements recognises that a potential conflict of interest could impact upon the provision of services and the disposal process. Whether the parties intended a 'potential' conflict to include a 'perceived' conflict, however, is not clear from the documentation. Further, each of the

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[83] Supplementary Report of the Auditor-General on 'Electricity Businesses Disposal Process in South Australia: Arrangements for the Probity Auditor and Other Matters: Some Audit Observations', at p 26.

Consultancy Agreements is silent as to the Treasurer's remedy if the Consultant does have a perceived or potential conflict of interest.

Ultimately, if there was a perception or a potential conflict of interest on the part of the Consultant which could undermine the disposal process and/or public confidence in that process, then the only apparent contractual solution is for the Treasurer to terminate this Agreement for convenience. In such a case the compensation arrangements would come into play.

The Crown Law Office[84] has indicated that:

> *If there is an actual conflict of interest the Consultancy Agreement deals with it. If there is a perception of conflict but no actual conflict there is nothing for which to hold the Lead Advisers to account because there is no disadvantage to the State if there is no actual conflict whatever the perception and mere perception can never found an action by a disgruntled bidder.*

While this view may be correct from a legal point of view, it does not recognise, in my opinion, the commercial damage that can occur from a lowering of public confidence in the disposal process. As a result it is not unusual for Governments to preserve their ability to terminate for a perceived conflict to allow themselves the broadest range of options should they face such a situation.

The lack of any contractual remedy to deal with 'potential material conflict' or potential conflict of interest was expressly recognised by the Crown Solicitor's Office in advice given to the ERSU in respect of the possible conflict of interest generated by an Adviser who later acted for a bidder during the disposal process.[85] In that advice the Chief Commercial Counsel stated, inter alia:

> *In the circumstances described in the papers I have received, I am satisfied that there is no actual conflict of interest and therefore there is nothing ERSU can do to prevent [the Adviser] from acting for a bidder unless it breaches its confidentiality obligations …*

In my opinion, the fact that the Treasurer cannot terminate for a potential or a perceived conflict of interest on the Consultant's part is passing to the State the risk that in the event of such a perception of a conflict of interest that undermines the disposal process, the Treasurer will have to utilise the termination for convenience provisions and pay compensation.

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84 Crown Law Report dated 22 August 2000.

85 Minute dated 15 October 1999 from the Chief Commercial Counsel to ERSU.

Audit Recommendation 11

I recommend that contracts for advisory services provide a mechanism for resolving potential and perceived conflicts of interest, should they arise. In this respect I recommend that consideration be given to inserting an express contractual term in the State's standard Consultancy Agreement to the effect that the consultant will not only notify any conflict (whether actual, potential or perceived) but also take whatever steps are required to address that conflict.

6.3.3 Meaning of Actual Material Conflict

As previously outlined, in some Agreements an actual conflict is not sufficient to exercise the right to terminate, but the conflict must also be 'material'. The term material, however, is not defined in the Consultancy Agreements.

In my opinion, the term material should have been clearly defined to reduce the risk of contract disputes in the case that a conflict of interest arises.

6.3.4 The Ability of Legal Advisers to Act for Financiers of Bidders

A literal interpretation of the clause in the Legal Advisers' Agreement allowing them to also act for financiers of bidders would be that, for the Treasurer to refuse consent all factors in the clause must be present (ie if there is a conflict, and either the release from financiers or the reasonably satisfactory assurance is available). If that was the case, then the consent cannot be refused. In my opinion, that arrangement is not a satisfactory position for the State.

I consider that these conditions do not adequately protect the State from actual or potential conflict of interest or liability concerns and, in my opinion, any legal firm comprising the consultant which also acts for a financier during Stage 3 would, ipso facto, have a perceived conflict. I consider that it would not have been unreasonable if the consultant had been expressly prohibited from providing legal or professional advice to any other party involved in the bidding process. If that prohibition was breached by any of the legal firms comprising the Legal Advisers then the normal contractual and equitable remedies would be available to the State.

Audit Recommendation 12

I recommend that significant consultancy contracts contain an express prohibition on the consultant acting for any interested third party (whether that interest is direct or indirect) in circumstances where an actual, potential or perceived conflict of interest could arise.

6.4 INDEMNITY

6.4.1 Background

The RFP asked proposers to state whether there was any area within the State's standard terms and conditions of contract with which the proposer would be unable to comply should they be selected. Although standard terms and conditions were not attached to the RFP, the following statement appeared under the heading 'Consultancy Terms and Conditions (Generally Indicative Only) (Final Terms and Conditions to be set out in a formal agreement)':

> *The Consultant must indemnify the Crown, against any loss or damage which either of them suffers as a result of any breach by the Consultant of any of its obligations to the Government under the Consultancy.*

Notwithstanding this requirement, when it came to finalising the Agreements with each of the Advisers, different indemnity arrangements were included. A summary of the negotiated positions follows.

Lead Advisers

The ultimately successful Lead Adviser consortium responded in their proposal that: 'The organisations confirm that there are no areas within the State's standard terms and conditions of contract with which they are unable to comply'.[86]

That consortium was selected as the Lead Adviser subject to contract negotiation. On 20 March 1998, the State sent a draft Consultancy Agreement to the consortium's legal advisers for comment. That draft contained a mutual indemnity and release under which each party indemnified the other for any loss or liability arising out of their negligence, omission or breach of contract.

The Lead Advisers provided comments on the draft by facsimile dated 25 March 1998. The facsimile included a marked up version of the draft contract, the effect of which was to remove any indemnity in favour of the State but to retain a State indemnity in favour of the Lead Advisers.

By facsimile dated 31 March 1998 the Crown Solicitor's Office replied to the Lead Advisers stating:

> *It is not clear to us from the amendments you have proposed to the Consultancy Agreement whether or not you are familiar with the lead up to its drafting. I attach a copy of the Request for Proposals which was issued by the Treasurer and to which your consortium responded. You will see that*

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[86] Paragraph 9 of the consortium's proposal of 27 February 1998.

request contains some indicative consultancy terms and conditions. In response to issue 9 … your consortium said:

> *The organisations confirm that there are no areas within the State's standard terms and conditions of contract with which they are unable to comply.*

This response was a factor in the selection of the consortium as the preferred Lead Adviser. To the extent that your position now resiles from the position stated in the response, the prospective engagement of your consortium as the Lead Adviser will not be able to be concluded until we can resolve the areas of difference.

In a facsimile dated 7 April 1998 the Lead Advisers replied:

… in a few cases we have reluctantly agreed to give up an indemnity from the client provided it is clear that our liability under the engagement is limited to particular situations where our conduct justifies that result … It is basically unheard of for us to indemnify the client …

Further exchanges followed and the indemnity from the State in favour of the Lead Advisers was withdrawn but the Lead Advisers continued to refuse to indemnify the State. Under the contract entered into by the parties, the Lead Advisers are released by the Government from any liability other than from liability arising from their bad faith, negligence or material breach of contract.

By contrast, another proposer for the Lead Adviser role indicated in their submission that they wished to obtain a cap on their liability under an indemnity in favour of the State in similar terms to the one they had received from the Government in a previous transaction. In explaining the reasons why that proposer was not short-listed, the ERSU stated[87] amongst other things:

There was also a potential difficulty with the indemnity likely to be sought by [the consortium]. In its proposal, [the consortium] indicated that it would seek a similar indemnity to that specially negotiated for … [a previous consultancy it had with the Government]. This special indemnity was accepted with considerable reservation at that time after a long period of negotiation … The … indemnity [used in the previous consultancy] is unlikely to be acceptable for this substantially larger project. Therefore [the consortium's] reservation about this contractual term was noted.[88]

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87 Minute to the Chief Executive on this issue dated 17 March 1998.

88 It should be noted that these comments about the indemnity were not the sole reason for not shortlisting the bidder in question. They are included merely to indicate the State's attitude to the request at the time.

Legal Advisers

The ultimately successful Legal Advisers consortium responded in their proposal that:

> ***South Australian State's Standard Terms and Conditions***
> *We do not believe there should be any problem in reaching a satisfactory contractual arrangement with the Government on all issues.*

A number of the potential legal firms/legal consortia flagged difficulties with the indemnity in their proposals. Whether any of the State's contractual terms and conditions were a problem for the short-listed legal firms/legal consortia was a topic raised by the Selection Panel (ie 'indemnity arrangements' were specifically flagged).

Following negotiations the Legal Advisers' Consultancy Agreement did not contain the standard indemnity provision in favour of the State.

Accounting Adviser

The ultimately successful Accounting Adviser put in two proposals in response to the RFP, one as part of a consortium, the other was a separate bid. The consortium proposal stated, inter alia: 'There are no areas of concern with the State's standard terms and conditions of contract'.[89]

The separate bid did not mention any issue in respect of giving an indemnity to the State. Further, the ERSU review team did not make any adverse comment in their evaluation of that proposal.

The Consultancy Agreement entered into by the parties contains no indemnity from the Accounting Adviser to the State. Audit was advised that this was as a result of a recommendation by the Crown Solicitor's Office to the ERSU. I note that similar difficulties were encountered in securing an indemnity from the Lead Advisers, and it was resolved not to pursue the inclusion of an indemnity in any consultancy contracts.[90]

Economic Adviser

The ultimately successful Economic Adviser was a member of a consortium that submitted a joint proposal to the RFP. The consortium responded in the following terms to the State's standard terms and conditions of contract: 'The organisations confirm that there are no areas within the State's standard terms and conditions of contract with which they are unable to comply'.[91]

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89 Paragraph 9 of the consortium's proposal dated 27 February 1998.

90 Advice provided by the Chief Commercial Counsel to Audit at a conference on 6 July 2000.

91 Paragraph 9 of the Morgan Stanley/Pacific Road/Putnam Hayes and Bartlett proposal dated 27 February 1998.

The review team took notes of any additional features offered in all of the proposals, as well as of any unusual proposed contract terms and conditions, such as cross indemnity arrangements. There were no comments recorded against this criteria indicating that any of the firms evaluated had any issue with the State's standard terms and conditions of contract.

No indemnity in favour of the State was included in the final Consultancy Agreement with the Economic Adviser.

Other Advisers

The Consultancy Agreements with the Actuarial, Communications, Engineering, Environmental and Project Manager Advisers all contain an indemnity in favour of the State.

6.4.2 Absence of an Indemnity

The Consultancy Agreements were material in monetary terms and relate to the provision of advice on which the State would place reliance. In these circumstances it is essential that the consultant is willing to take responsibility for the advice provided by entering into appropriate indemnity provisions.

The requirement for an indemnity in favour of the State was clearly stated in the RFP and the Advisers' responses indicated that they would be able to comply with that requirement.

Audit was advised by the Chief Commercial Counsel of the Crown Solicitor's Office that the omission of the indemnity in favour of the State from some Consultancy Agreements was due to his recommendation to the ERSU, after difficulties encountered in securing an indemnity during negotiations with the Lead Advisers. The recommendation was based on an opinion that the inclusion of indemnities added nothing to the liability regime the law of contract provides.[92]

Notwithstanding this, indemnities were included in the agreements with the Actuarial, Communications, Engineering, Environmental and Project Manager Advisers. I set out at Attachment A to this Report a brief explanation of my understanding of the benefit of including an indemnity in such Agreements.

Although the State conceded on the issue of the indemnities when finalising the Agreements, there is no documented risk assessment of this decision, nor was there evidence that the proposals had been reassessed against others, taking the matter of indemnities into account.

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92 Crown Law Report dated 22 August 2000.

Audit Recommendation 13

I recommend that the State obtain an indemnity from any consultant providing expert advice where the contract is high value and reliance will be placed on the advice, such that the State is potentially exposed to liability should that advice prove to be defective.

Audit Recommendation 14

I recommend that where a proposer, who has been selected subject to contract negotiation, deviates significantly from the initial offer in those negotiations, the proposal be re-evaluated against other proposals, taking into account the deviation.

6.4.3 Documentation of Advice

Given the significant value of the services and the potential for significant liability for the State should the services be deficient, I would have expected the Crown Solicitor's Office to provide the ERSU and the Treasurer with comprehensive written advice as to the liability regime and the implications of not obtaining an indemnity.[93]

I am also of the opinion that the matter as to whether or not an indemnity should be obtained from all Advisers was a matter on which the Crown Solicitor's Office should have sought instructions from the Treasurer. The instructions from the Treasurer would have been based on the comprehensive advice provided by the Crown Solicitor's Office as to the advantages and disadvantages of the particular approach.

Audit Recommendation 15

I recommend that where the Crown Solicitor's Office provides advice on contractual matters, particularly in relation to the liability to be assumed by the State, that advice be appropriately documented.

Further, I recommend that where a contract is prepared by the Crown Solicitor's Office, that contract be based on instructions from the requesting party (documented by the Crown Solicitor or the instructing party).

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[93] Audit was advised by the Chief Commercial Counsel at a conference on 6 July 2000 as to the events surrounding the preparation of the draft consultancy contract without inclusion of an indemnity provision.

6.4.4 Review of Contract by SAICORP

The Department of Treasury and Finance Guidelines for the Use of Consultants/Contractors requires that:

> *Certain contracts should be referred to SAICORP for review. These contracts may be high-risk exposure, of a politically sensitive nature, of substantial cost, of an unusual nature, or purport to cap liability.*[94]

The contracts with the Advisers were not, however, referred to SAICORP.

Crown Law has advised[95] that because the Treasurer is the Minister for SAICORP, the agreements were not referred to SAICORP. Instead, the Treasurer's approval based on the advice of Crown Law was considered sufficient to meet the guidelines. I have already noted, however, that the advice provided by Crown Law, particularly in relation to liability and the removal of an indemnity was provided in discussion and not in writing.

In my opinion, value could have been added by obtaining a SAICORP analysis of the risk presented by the contract, which advice could have been presented to the Treasurer in addition to the Crown Solicitor's Office advice to assist the Treasurer to make his final decision.

Audit Recommendation 16

I recommend that all significant consultancy agreements, particularly those with a high risk exposure, or where there is a cap on liability, be referred to SAICORP for review.

6.5 LIABILITY REGIME

In addition to not indemnifying the State, the Lead Advisers sought a limitation of their liability under the Agreement. This was agreed to by the State and clause 9 in the executed Agreement provided that:

> *The Consultant's Group will have no liability to the Client (whether the liability is direct or indirect or arises in contract, in tort or otherwise) in respect of the Services or the Project except for any such liability for losses, claims,*

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94 Department of Treasury and Finance Guidelines for the Use of Consultants/Contractors, Appendix 3 'Procedures for the Engagement of Consultant's Services', section 5 'Engagement and Contractual Arrangements'.

95 In the conference between Audit and the ERSU on 6 July 2000.

damages, liabilities or expenses which are suffered or incurred by the Client and which:

(a) result from the bad faith, or negligence of the Consultant's Group; or

(b) result primarily from a material breach of contract by the Consultant's Group and in that case the liability of the Consultants group is strictly limited to A$22 million.[96]

In discussing the cap on liability being sought by another proposer, reference was made to a previous arrangement where liability was capped at five times the fees payable and:

> *… was accepted with considerable reservation at that time after a long period of negotiation … [That form of] … indemnity is unlikely to be acceptable for this substantially larger project because the Government will likely place some degree of reliance on the consultant's advice. The Government's exposure to bad advice is significant and is likely to be beyond an arbitrary cap of, say, 5 times $20m fees.*[97]

Audit Comment

Under the clause finally agreed between the two parties, the Lead Advisers are liable to the full extent for loss or damage resulting from its bad faith or negligence. Because the Lead Advisers do not indemnify the Government, the Government does not have a contractual right to be paid these damages, and legal action would have to be taken to obtain judgment against the Lead Advisers in respect of any such liability unless the Lead Advisers otherwise agreed to pay the Government. Liability for 'material breach of contract' is capped at $22 million although the term 'material breach of contract' is not defined. It is likely though that not performing the services 'professionally, carefully, skilfully and competently' as required by clause 5.2(a) of the Agreement would be a material breach. Liability for any breach of contract which is not 'material' or does not result from the Lead Advisers' bad faith or negligence is completely excluded.

I have previously referred to the requirement for certain contracts to be referred to SAICORP for review and the response from the ERSU that, because the Treasurer is the Minister for SAICORP, the Agreement was not referred to SAICORP.

Notwithstanding the non-referral to SAICORP, I note the Crown Solicitor's Office advice that the concluded contract position was the best position it could negotiate, and was a solution which represented acceptable risk to the Government. The Crown Solicitor's Office has also

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96 Clause 9 of the Consultancy Contract with the Lead Advisers dated 15 April 1998.

97 Minute to the Chief Executive, Department of the Premier and Cabinet 'Electricity Reform and Sale Program Appointment of Lead Adviser' dated 8 April 1998.

indicated that no formally documented risk analysis was undertaken, although legal advice was given by that Office to the other negotiators that clause 9 was acceptable.[98]

I am not aware, however, of any circumstances which would warrant a change from the position taken at the time of short-listing. The Government was to place a high degree of reliance on the Lead Advisers' advice. In the event of a material breach of contract the damage to the State is likely to be beyond an arbitrary cap to a position which allowed the exclusion of some liability and a cap of $22 million in respect of other liability.

Audit Recommendation 17

I recommend that agreement to cap liability should only be given after a full risk assessment has been undertaken and documented, showing why a cap is justified and what the size of the cap should be in order to best protect the State.

6.6 SUCCESS FEES AND MONTHLY RETAINER

Lead Advisers

When initially reviewing the proposals, the review team gave little consideration to the fees being proposed as it was expected that fees would be the subject of direct negotiation with the short-listed proposers.[99] In fact, the ultimately successful consortium proposed an indicative monthly retainer significantly higher than that sought by the other three short-listed consortia. This figure increased during contract negotiations although this was partially offset by a reduction in the success fee being sought by the consortium. Audit notes that success fees were sought by all the short-listed consortia and were in a similar range.

Accounting Adviser

The Accounting Adviser's fee structure is set out in Annexure B 'Fee', of the Schedule to the executed Consultancy Agreement and includes:

- a 'Time Related Fee' in the form of hourly rates to be charged for services provided;
- an Incentive Bonus (hereafter described as 'success fee') to be paid upon the achievement of specified aggregate proceeds from the disposal process.

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98 Minute dated 13 April 2000 from Crown Solicitor's Office to the ERSU setting out answers to questions posed to the ERSU by Audit.

99 Minute to the Chief Executive, Department of the Premier and Cabinet 'Electricity Reform and Sale Program Appointment of Lead Adviser' dated 8 April 1998.

Of the other two shortlisted 'general accounting' firms one proposed fees on a time charge basis while the other also proposed fees on a time charge basis with a success fee built-in (ie that the firm would receive a certain percentage above its standard daily rates if disposal proceeds achieved a specified amount).

The Accounting Adviser gave the following rationale for the presence of an Incentive Bonus:

> *We consider that it is in our joint interests for our remuneration to incentivize us to achieve the Government's objectives. The 'product' we offer is not a commodity, we know we will demonstrably add significant value to the success of the program. We expect our role will extend far beyond the 'traditional scope' of an accounting and tax adviser; it would perhaps be better titled as a commercial and business adviser role.*[100]

Audit Comment

The negotiation of the above fees in the Consultancy Agreement, in my opinion, gives rise to the following issues.

6.6.1 Timing of Fee Negotiations

I note that most of the negotiation of the fee structure took place after the Advisers had been selected, subject to contract. Although it could be argued that the matter of the level of fees to be paid to the successful proposer was of secondary importance to the assessment of the ability of the proposer to provide advice of the highest quality, the expected quantum of fees to be paid represents a significant amount.

It is my opinion that the issue of fees should be a matter that is actively negotiated at a time when there remains considerable competitive pressures among a number of potential proposers. As a result, it is my opinion, that a better result may have been obtained had fees been negotiated before selection and the fee structure given more consideration in the evaluation process.

Audit Recommendation 18

I recommend that consideration of the fee structure to apply under consultancy contracts be undertaken during the evaluation and selection of advisers. Where fee structures need to be negotiated, this should be done at a stage when the competition between proposers is still active.

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[100] Letter dated 16 April 1988 from KPMG to the Under Treasurer.

6.6.2 Implications From the Use of Success Fees

With respect to the disposal of the government-owned electricity businesses, the mechanisms established to satisfy those objectives include:

- the decision making committees/individuals being predominantly public servants (notwithstanding that they would be relying heavily on the advice of the Lead Advisers);
- the majority of other advisers (including Legal Advisers) being contracted on a fee for service basis.

In my opinion, these arrangements provide an opportunity for those responsible for key decision making to receive appropriate advice with respect to matters of risk associated with the disposal of the Government's electricity businesses.

Although maximising revenue from the disposal is a State objective, it is coupled with the further objective of minimising the risk to the State of the disposal, and it is important that advice received is balanced in terms of both objectives.

The use of a success fee structure, where the amount of fees paid to advisers is dependent upon 'the consideration paid for the asset being disposed of', gives rise to a potential risk that advisers may be influenced by a desire to maximise the consideration paid for the asset in the giving of advice to the State about the disposal without adequate regard to the risks assumed by the State in the process.

There is no documentary evidence as to why a success fee was agreed with the Accounting Adviser. However, the ERSU has advised[101] that the State particularly wished to secure the services of the Accounting Adviser because of its recent experience in the Victorian disaggregation and disposal of electricity assets and thus a success fee was agreed. The ERSU also indicated that the negotiation resulted in lower hourly rates as a trade-off.

While I note the rationale advanced by the Accounting Adviser for the success fee, it is my understanding that the Lead Advisers were and are the 'commercial and business adviser' to the Project. In any event, from an accountability perspective I note that there is no documented rationale why the Accounting Adviser was to receive a success fee over and above the standard hourly rates charged. The Lead Advisers and the Accounting Adviser are the only two consultancies which contain a success fee regime. I note that other key advisers giving professional advice in the disposal process such as the Legal Advisers, Economic Adviser and the Engineering Advisers do not receive a success fee.

According to the ordinary impulses of human nature, the private interest of the Lead and Accounting Advisers could lead them to try to make the price as high as possible. The higher the price the greater would be their remuneration. At the same time they were closely involved in the analysis of the matter of the commercial acceptability of the risk. In making

[101] In the conference between Audit and the ERSU on 6 July 2000.

this observation there is no evidence that this in fact did happen. This analysis of risk was to be made, not only against pre-established benchmarks, but also as against risks that were not subject to pre-established benchmarks and where the benchmarks with respect to the latter mentioned risks was determined only after the bids had been received and opened. In my opinion, in these circumstances, the arrangements established by the ERSU did not reflect sound administrative practice, and in fact, placed the State in a potentially prejudicial position.

In conclusion, I am of the opinion that the State should not have agreed to pay a success fee unless it could be demonstrated to be clearly in the best interests of the State, ie the successful firms were the only firms able to perform the consultancy services to the required standard and would not have contracted without a success fee component.

Audit Recommendation 19

I recommend that a success fee arrangement only be agreed for the engagement of a consultant where it is demonstrably in the interests of the State to do so, ie a success fee arrangement will ensure a better outcome for the State or the State cannot obtain the necessary consultancy services without agreeing to a success fee arrangement.

I further recommend that the rationale for entering into a success fee arrangement be clearly articulated and documented for accountability purposes.

Audit Recommendation 20

I recommend that where a success fee arrangement must be used in order to engage a consultant, consideration be given to establishing other measures to ensure the advice received is not unduly influenced by the opportunity to receive an incentive.

6.6.3 Mechanisms for Reduction of Fees

At the time the Advisers were engaged to advise the Government on the disposal of its electricity businesses, existing legislation did not allow the Government to proceed with the sale of a number of prescribed electricity assets.[102] Further, there was a likelihood that such legislation would not be passed by Parliament in the near future. In these circumstances, it would be a reasonable expectation that the full services of the Advisers may not be required.

The mechanism included in the contract for the reduction of fees in the event of a decreased requirement for services relies on negotiation at the time of the decrease in service.

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[102] Prescribed electricity assets are those defined by subsection 13(6) of the *Electricity Corporations (Restructuring and Disposal) Act 1999*.

In my opinion, given the Government was aware there was a likelihood that there would be a need to reduce the requirement for services under the contract, the better practice would have been to include a more certain mechanism within the contract for reducing services.

Audit Recommendation 21

I recommend that contracts for consultants/advisers include firm contractual arrangements to apply to all events that could reasonably be expected to occur.

6.7 INSURANCE

6.7.1 Background

The arrangements for insurance differ from Agreement to Agreement.

Lead Advisers

The insurance under the Lead Advisers' Agreement is on the basis that one of the members of the consortium was able to self-insure. On this basis clause 11.5 of the executed contract provides:

> *The Consultant acknowledges that in entering into this Agreement, the Client has relied on the assurances given it by Morgan Stanley, Dean Witter and Co in the letters comprising Annexure C that it has insured Morgan Stanley Australia Limited (partly as self insurer and partly through third party insurers) as described in the letters and that it will continue to do so throughout the term.*

Accounting Adviser

As part of the contractual negotiations with the Accounting Adviser, two letters originating from KPMG's worldwide insurance brokers, were passed to the State. The first letter dated 27 April 1998, states that KPMG Australia participates in an international professional indemnity insurance program and that the policies arranged under the program comply with the requirements of the Institute of Chartered Accountants in Australia, Regulations Relating to Certificates of Public Practice, including the requirement under regulation 7PI.4(e)(i) that:

> *The sum insured for the practice must not be less than:*
>
> *(a) The amount calculated by multiplying the number of principals as to the beginning of the period of insurance by $250 000 for each and every claim; or*
>
> *(b) $100M in the aggregate for all claims during the period of insurance;*
>
> *whichever is lesser.*

The second letter dated 28 April 1998 states that the 'total limit of liability exceeds the amount calculated by multiplying the number of principals by $250 000 for each and every claim'.

These letters form Annexure C and D respectively to the Schedule of the Consultancy Agreement. The insurance clause reflects the State's acceptance of these insurance arrangements.[103]

Environmental Advisers

The Consultancy Agreement for Energetics specifies in the schedule that the Consultant must maintain Public Insurance and Professional Indemnity Insurance cover of $10 million for each. The Consultancy Agreement for Hyder Consulting specifies in the schedule that the Consultant must maintain Public and Product Liability Insurance cover of $10 million and Professional Indemnity Insurance cover of $10 million for any one loss or occurrence and $20 million in aggregate in any one period.

Economic Adviser

The Consultancy Agreement for the Economic Adviser (PHB) provides in clause 11:

> *The Consultant acknowledges that in entering into this Agreement, the Client has relied on the assurances given it by Putnam, Hays and Bartlett, Inc. in the letter compromising Annexure C that, as self insurer, it has insured the Consultant as described in that letter and that it will continue to do so throughout the term.*

Annexure C contains a letter to the Treasurer dated 24 April 1998 from Putnam, Hayes and Bartlett Inc (PHB Inc) which states that PHB Inc is a corporation validly incorporated under the laws of the Commonwealth of Massachusetts, USA. The letter confirms that PHB Inc owns 100 percent of the issued capital of the consultant; that PHB Inc self insures against and indemnifies for professional indemnity claims of its related bodies corporate and subsidiaries including the consultant and that:

> *[PHB Inc] certifies that:*
>
> *(c) PHB-AP Pty will be entitled to the benefit of the self insurance indemnity at all times relevant to the delivery of advice on the above-described Project.*
>
> *We acknowledge that if you enter into the Consultancy Agreement described above, you will do so in reliance on this letter and the assurances contained in it.*

The presence of the above insurance arrangements, in my opinion, give rise to the following issues.

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[103] See clause 11.1 Insurance of the Consultancy Agreement.

6.7.2 Adequacy of Self-Insurance Arrangements

An assurance by a party is only as good as the authority, solvency and amenability to legal process of the individual or entity giving the assurance. I note that there is no documented assessment of the risks to the State associated with accepting self insurance of a consultant by its US parent company. The Crown Solicitor's Office has advised, however, that an assessment was made at the time, although it was not documented.[104]

In my opinion, the analysis that the Crown Solicitor's Office undertook at the time was inadequate in that it did not conclude that the lack of privity of contract between the Government and a Lead Adviser's US parent would cause a difficulty in enforcing the assurances made by that US parent.

In my opinion, there is significant potential risk involved with trying to enforce in South Australia assurances made by a US based company to its subsidiary when the US company is not party to the contract.

Audit Recommendation 22

I recommend that where a parent company is effectively taking the place of the insurer, consideration be given to making the parent company a party to the contract.

6.7.3 Examination of Policies

The letters provided by the Accounting Adviser are clearly holding out that the policies referred to do cover the Accounting Adviser,[105] although this can only be verified by examining the actual policies. There is no evidence that this examination was undertaken.

In my opinion, in respect of consultancies of this significance the State should, as a matter of both practice and procedure, obtain copies of all relevant insurance policies from the contractor and satisfy itself that the insurance arrangements in terms of quantum of cover, exemptions to the policies etc are satisfactory to protect the State's interests. Further, I consider that the State's interests should be noted on the policies.

I note Crown Law's opinion[106] that there are three issues associated with the examination of the policies. First, that examination may have exposed the State to liability in that their examination and acceptance of the policies would prevent the State from later arguing that

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104 Minute dated 13 April 2000 from the Crown Solicitor's Office to the ERSU setting out answers to certain questions posed by Audit to the ERSU.

105 'The policies provide coverage for KPMG its Principals and all corporate entities including KPMG Corporate Finance (Vic) Pty Ltd ACN 007363215.' letter of 28 April 1998.

106 Crown Law Report dated 5 October 2000.

the insurance policies were inadequate for the purposes of the contract. I agree that such a risk exists, however, it can be minimised by using a professional insurance adviser to advise on the adequacy of the insurance arrangements in the context of a thorough risk assessment.

Second, Crown Law suggests it may have relied on SAICORP to confirm the reliability of the certificate provided by AON. I have seen no evidence that SAICORP's advice was obtained. In fact, Crown Law has previously stated[107] that SAICORP was not involved in reviewing the agreements.

Third, Crown Law suggest that KPMG may have objected to disclosure on the ground that disclosure would be a breach of the policy. That would of course be a matter for KPMG to raise and one cannot be certain that the issue would have been raised were they asked to disclose. However, it is my experience that such objections are not insurmountable. The terms and conditions that the third party insurer wishes not to be disclosed are often not the terms and conditions that the State needs to see to satisfy itself of the coverage provided by the policy.

I consider that precautionary measures, such as the examination of the policies and the noting of the State's interests on the policies, are more important where, as here, the State does not have the benefit of an indemnity from the other party.

Audit Recommendation 23

I recommend that the State, for all consultancies where the State's exposure in the event it receives incorrect advice is potentially significant, obtain, where possible, copies of all relevant insurance policies from the consultant to verify that the insurance arrangements are satisfactory to protect the State's interests.

6.7.4 Adequacy of Insurance Cover

I note that the extent of the coverage of professional indemnity insurance for 'KPMG Australia' is for 'each and every claim' during the period of insurance. Having regard to the scale of the disposal process and the services being provided by the Accounting Adviser, I am concerned as to whether the amount of cover is sufficient to protect the State from risk and liability exposure. In this respect I note that the Legal Advisers' professional indemnity insurance coverage is significantly higher.

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[107] Refer to commentary in this Report under the heading '6.4.4 — Review of Contract by SAICORP'.

I also have some concerns whether the level of insurance cover specified for the Environmental Advisers is sufficient to protect the interests of the State. The Government's potential liability exposure as a result of incorrect advice from the environmental consultants is also significant. Although both Environmental Adviser Agreements contain in clause 10 an indemnity in favour of the Government, the utility of these indemnities is only certain from the Government's perspective if they are backed with adequate insurance cover. I note that other key advisers such as the Legal and Accounting Advisers have Professional Indemnity Insurance of considerably more value. Moreover, the Engineering Advisers, with whom the environmental consultants have been compared by the Government, have Public and Product Liability Insurance cover of $20 million and for Professional Indemnity Insurance $20 million for any one incident and $40 million in aggregate in any one period. However, some intellectual process was apparently brought to this exercise — the fact that the Professional Indemnity Insurance cover for Energetics is $10 million and for Hyder is $10 million for any one loss or occurrence and $20 million in aggregate presumably reflects Hyder's more significant role as the 'primary environmental consultant'.

I note that there is no documented assessment of the risks to the State associated with accepting the various levels of cover.[108]

Audit Recommendation 24

I recommend that the State, for all consultancies where the State's exposure in the event it receives incorrect advice is potentially significant, conduct a risk analysis to determine what insurance arrangements the contracted party needs to have in place to protect the State's interests.

6.7.5 Enforceability of the Assurance from the Economic Adviser

The legal status of the assurances given by PHB Inc is unclear. They are clearly representations intended to induce the State to enter into the Consultancy Agreement and as such are probably legally enforceable. There is no documentary evidence that the ERSU obtained legal advice from the Crown Solicitor's Office or elsewhere on the status and legal enforceability of the PHB Inc letter of 24 April 1998.

I am concerned that if circumstances arise whereby the State brings a liability claim against the Economic Adviser there may be administrative, legal (including jurisdictional) and other practical difficulties enforcing the assurances given by PHB Inc should the latter either choose not to honour those assurances or dispute the scope of the assurances. Although under clause 18.7 of the Consultancy Agreement the laws in force in South Australia are the proper law of this Agreement and under clause 18.8 the courts of South Australia have exclusive jurisdiction to determine any proceedings in relation to this Agreement, if neither

[108] Documentation of the risk assessment undertaken appears in the Minute from Crown Law to the ERSU dated 13 April 2000, considerably after the time of execution of the adviser contracts.

the consultant nor PHB Inc have sufficient assets in the jurisdiction which can be attached to satisfy any judgment then proceedings to enforce the assurances given by PHB Inc may have to be taken in the United States.

I am not suggesting that PHB Inc would choose not to honour its 'self-insurance indemnity' or would dispute its scope. I am merely noting the potential difficulties the State may face in the event of a dispute. In my opinion, there is significant potential risk involved with trying to enforce in South Australia assurances made by a US based company to its subsidiary when the US company is not party to the contract.

The standard requirement in many Government Consultancy Agreements (including the standard South Australian terms and conditions of contract) that the consultant indemnify the Government, and that such indemnity be supported by appropriate insurance provisions where the Government's interest is noted, is designed to protect the State from legal and financial risk arising from the consultant's default.

The fact that the Consultancy Agreement for the Economic Adviser does not require insurance cover (coupled with the lack of an indemnity) means that the State is bearing a greater financial risk and potentially greater liability exposure. In the circumstances, in my opinion, it would have been appropriate to insist that the consultant take out professional indemnity insurance coverage within Australia or that the consultant or PHB Inc provide some form of appropriate financial security in favour of the State. I note that the premium payable in taking out professional indemnity insurance is merely a cost of doing business, usually factored into the consultant's fee structure.

Audit Recommendation 25

I recommend that:

(a) the State only agree to self insurance arrangements in circumstances where the State's potential liability exposure as a result of defective advice is low and the benefits of employing the Consultant otherwise outweigh the detriment of self insurance, or the risks are effectively uninsurable;

(b) the State not accept the self insurance of a contractor unless it is satisfied that the self insurance arrangements will be able to be enforced within South Australia in a similar manner to an insurance policy.

6.8 TERMINATION

The Consultancy Agreements contain provisions in relation to three particular areas of termination. These areas are discussed below.

6.8.1 Termination by Treasurer Without Cause

The Treasurer has a right to terminate each contract without cause by giving the Advisers notice in writing.[109] In the case of the Lead and Accounting Adviser's they are then entitled to:

- remuneration for work performed to the date of termination;
- an additional three months worth of fees if the termination occurs before the commencement of the sale process activities;
- if the termination occurs after the commencement of the disposal process activities but before the Information Memorandum for an asset is prepared and the asset is subsequently disposed of by the State within 12 months of the date of termination, one quarter the success fees applicable to that asset;
- if the termination occurs after the commencement of the sale process activities and after the information memorandum for an asset is prepared and the asset is subsequently sold by the State within 12 months of the date of termination, the whole of the success fees applicable to that asset.

Audit Comment

I note that the inclusion of a right for the State to terminate without cause is a common requirement, necessary to allow for changes in government policy. Generally speaking such clauses allow for termination on the basis that a contractor is paid for the work performed and any other liabilities reasonably incurred to the date of termination. Although the Lead and Accounting Advisers have a significant team of people dedicated to the disposal process, I am of the opinion that the generous nature of these provisions, which allow for specific sums to be paid rather than being linked to compensation of reasonable costs incurred, in effect operate as a financial penalty against the State if termination for convenience is utilised.

Audit Recommendation 26

I recommend that provisions for payment of consultants in circumstances where contracts are terminated by the State without cause be formulated on the basis that the payment is to be reasonable compensation for work performed and liabilities incurred to the date of termination and not in respect of any anticipated profit to be made on the project.

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[109] Clause 14.6 of the Consultancy Agreement.

6.8.2 Termination by Lead Advisers Without Cause

The Lead Advisers also have the right to terminate the contract without cause in certain circumstances. Clause 14.8 of the Consultancy Agreement provides that:

> *The Consultant may terminate this Agreement without cause:*
>
> - *within the first 12 months of the term by giving the Treasurer six months' written notice to that effect; and*
> - *thereafter by giving the Treasurer three months' written notice to that effect.*

Audit Comment

It is unusual to give a consultant a right to terminate for convenience and this clause was inserted in the contract during negotiations, notwithstanding that it is inconsistent with the State's standard terms and conditions for the engagement of consultants. The ability of the Lead Advisers to terminate by giving three months written notice after the first 12 months of the term has the potential to adversely affect the disposal process.

The financial costs to the State may take a number of forms, including the cost of engaging new Lead Advisers, the delays in receipts from any disposals, and would be of major moment. This clause imposes risks on the Treasurer in terms of the disposal process including loss of bargaining power. If this right needed to be conferred then it would have been appropriate for it to have been qualified by requiring the consultant to meet the costs involved in engaging another lead adviser (especially since the Treasurer has agreed to pay significant additional fees if he terminates without cause) and requiring the consultant to cooperate fully with the new Lead Adviser over the transitional period.

Audit Recommendation 27

I recommend that consultants not be given rights to terminate without cause, or where these must be conceded, that an obligation to fully compensate the State for the costs of engaging an alternative adviser be included.

6.8.3 Termination for Abandoning the Project

In some of the Agreements there is a clause providing for termination on abandonment of the underlying project.

This clause provides that if the Government of South Australia abandons the Project prior to the disposal of any of the electricity assets it may terminate the Agreement on one month's notice and pay to the consultant, in addition to any outstanding remuneration to which the consultant is entitled, an additional two months' fees.

If the Treasurer or the Government or the State of South Australia resumes the disposal process within 12 months of the date of termination the Treasurer will be deemed:

- not to have abandoned the Project;
- to have terminated this Agreement under the termination without cause clause.

Audit Comment

This clause means that the consultant will be entitled to receive the much more generous termination payments conferred by the termination without cause clause if the disposal process is recommenced within 12 months of the date of abandonment. This is a generous provision, especially having regard to the fact that the Project may be abandoned because of defects in the original disposal process for which the Treasurer was unable to terminate with cause (such as the perception of conflict of interest), defects to which the consultant may have contributed.

The substance of Audit Recommendation 26 addresses this matter.

PART 7
CONTRACT MANAGEMENT

This Part of the Report comments on matters relating to the management of the Consultancy Agreements by the ERSU.

7.1 COMMENCEMENT OF SERVICES

A number of the Consultancy Agreements were not executed until after services commenced. Examples include:

- Legal Advisers — the Specified Commencement date was 27 April 1998, although the Agreement was not signed until 6 May 1998;
- Actuarial Advisers — the Specified Commencement date was 15 April 1998, although the Agreement was still being negotiated and amended in late April 1998. The contract executed is undated;
- Economic Adviser — although there is no commencement date specified in the Agreement, the advisers were paid from 20 April 1998. The agreement is dated 6 May 1998;
- Engineering Advisers — the Specified Commencement dates were 25 May 1998 and 5 June 1998, although draft agreements were not sent to the advisers until mid-June 1998. The Agreements were executed in October 1998 and January 1999.
- Environmental Advisers — the Specified Commencement date was 1 June 1998 although draft agreements were still being amended in August 1998. Both of the Agreements executed are undated.

Audit Comment

The purpose of the date in the Consultancy Agreement is to show when that Agreement was entered into by the last party (here the Treasurer) thereby being the date of the formation of the contract (ie when contractual relations are created).[110]

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[110] Where services have already commenced at the time when a contract is entered into the following advice is relevant:

> *… if {the parties] intend that the agreement should start operations from a date earlier than that on which it was signed, a clause to that effect should be inserted. The agreement should not be ante-dated. A clause which provides that an agreement shall be deemed to come into effect on a date prior to the date of signature is only effective as regards the parties to it: it cannot prejudice the position of other persons: A J Berg, Drafting Commercial Agreements, (1991)*.

The Advisers were not providing services between the date of commencement and the date of contract execution in a legal vacuum. They were doing so under the terms of a contract which is unknown to Audit; ie there was either an oral contract based on the representations of the parties or a contract partly oral/partly in writing or a contract based on other writing. There could have been a contract based on writing in place for this period — the writing perhaps comprising the RFP, the adviser's proposal, relevant correspondence between the parties as at the date of commencement and those clauses of the draft Consultancy Agreement agreed as at that date.

In any event this is, in my opinion, an unsatisfactory position. The rationale for the usual government contracting requirement that a written contract be in place before goods or services are delivered is that a written contract provides certainty and minimises the scope for dispute about contractual terms, thereby protecting taxpayers' interests. If work is performed by a contractor before a formal contract is signed, that work is unlikely to be covered by specific contractual terms such as warranties, indemnities or provisions about payment.

Notwithstanding this, it is not unknown for a consultant to commence providing services before a formal contract is agreed. This situation usually arises where the need for consultancy services is urgent and immediate. In those circumstances it is essential that the terms of the consultancy agreement be negotiated, contain a clause which deals with the work already done, and the consultancy agreement be executed as soon as possible.

In my opinion, that situation is far from ideal. The very pressures that make it tempting to allow a consultant to start work before a contract is signed serve to potentially weaken the State's bargaining position. Once the consultant has started work, the incentive to make concessions imposed by competition is almost gone and, for the same reason, it is even more difficult for the State to 'walk away' from negotiations over the contract.

Further, in some cases the Agreements are undated and their language is prospective in nature (that is they indicate when the agreement will commence). I note that, in respect of the Agreements that are undated, if a contractual dispute arose between the Treasurer and the Consultant extrinsic evidence would be necessary to establish the date of formation of contract.

In my opinion, good procurement procedures and management should ensure that the circumstances in which a contractor or consultant must commence delivering goods or services prior to a written contract being in place are exceptional.

Audit Recommendation 28

I recommend that it be a basic principle of government procurement that no goods or services be delivered until a written contract is in place. Where a contractor or consultant must commence delivering goods or services prior to a written contract being in place, I recommend that the terms of the contract be negotiated and the contract be executed as soon as reasonably practical.

I also recommend that, in such circumstances, there be an express provision in the contract that makes clear that the contract is intended to operate retrospectively to the date when the goods or services were first delivered.

7.2 SUSPENSION OF THE CONTRACT

7.2.1 Background

Lead Advisers

In the previous Part of this Report I referred to an issue relating to the mechanisms in the Lead Advisers' Consultancy Agreement for the reduction of fees where the requirement for services decreases.[111]

By early December 1998 it became evident that the passage of the disposal legislation was problematic. The ERSU discussed with the Treasurer on 10 December 1998 implementing arrangements to ensure that only 'necessary or unavoidable costs' were incurred in the period until end February 1999,[112] when the fate of the disposal legislation would be clearer. In respect of the Lead Advisers consultancy the Treasurer approved that the fixed monthly fee remain in place, until review in mid February 1999 of the ongoing contract.[113]

Audit notes that the Lead Advisers in a Memorandum to the ERSU dated 11 December 1998[114] advised that, in accordance with instructions, all privatisation work would cease at the end of that week. The Lead Advisers also advised that other work in relation to the restructuring of the government-owned electricity businesses, and the 'new entrant' process would be completed by mid-February 1999.

In February 1999, the disposal legislation was re-presented to Parliament but not passed.

The ERSU documentation shows that negotiations between the ERSU and the Lead Advisers in respect of suspending the Consultancy Agreement occurred in January,

111 Under the heading in this Report '6.6.3 — Mechanisms for Reduction of Fees'.

112 Minute to the Treasurer 'ERSU Arrangements from 10 December', dated 22 December 1998.

113 ibid.

114 Lead Adviser Memorandum to the ERSU, 'Revised Work Program', dated 11 December 1998.

February and March 1999. By letter dated 15 April 1999 to the Lead Advisers the Treasurer offered to '… vary the Consultancy Agreement made between us on 15 April 1998 to allow for its suspension on the terms and conditions outlined in the attached documents'.[115] The Lead Advisers accepted the terms of the suspension with some clarifications.[116]

The Treasurer wrote to the Lead Advisers on 8 August 1999 noting that the disposal legislation had been passed on 11 June 1999 before a formal agreement for the suspension of the Head Contract could be executed. He proposed that the parties proceed as if the draft Amending Agreement had been signed and as if a Reactivation Notice (as defined in the draft Amending Agreement) had been given on 12 June 1999. This meant that the suspension period would be from 15 April 1999 to 12 June 1999.

The effect of the suspension was that the State had to pay for any services provided during the suspension period plus the amount to which the Lead Advisers would have been entitled if the Head Contract had been terminated under clause 14.9 of that contract. This amounted to fees and allowances for a one month notice period plus two months' fees. However, the two months' fees could be offset against fees paid to the Lead Advisers after the contract was reactivated.

Legal Advisers

The ERSU in a minute to the Treasurer dated 24 March 1999 recommended that the Consultancy Agreement with the Legal Advisers be suspended '… on the basis that additional work might be commissioned from time to time under the existing contract'. A variation to the Consultancy Agreement to give effect to this suspension was drafted. Under the variation (clause 3(b)) 'the Consultant firms are free to act for others without obtaining the prior consent of the Client'. This variation effectively negates clauses of the agreement relating to conflicts of interest. The variation, however, does not make provision in the event that a firm does act for a potential bidder or financier during the suspension period. The ERSU has advised[117] that the variation was discussed at length with the Legal Advisers but was not effected and the Legal Advisers' contract was not formally suspended.

Accounting Advisers

The Executive Director, Commercial and Sale wrote to KPMG on 23 April 1999 enclosing a draft set of principles for a suspension agreement.[118] The draft included a provision that allowed KPMG to act for others during the period of suspension without obtaining the consent of the Government.

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[115] Letter dated 15 April 1999 from the Treasurer to the Lead Advisers and the letter dated 23 April 1999 from the Lead Advisers to the ERSU.

[116] Memorandum dated 15 April 1999 from the Treasurer to the Lead Advisers and the letter dated 23 April 1999 from the Lead Advisers to the ERSU.

[117] Letter dated 19 June 2000 from the ERSU to Audit.

[118] The draft was headed: 'Accountancy Advisors Consultancy Agreement — Some Suggestions for Amendment'.

By letter dated 5 May 1999 to the ERSU, KPMG agreed the amendments were acceptable. On 8 August 1999 the Treasurer wrote to KPMG confirming that both the Electricity Project and the Consultancy Agreement had been reactivated. The ERSU have advised,[119] however, that the actual reactivation date was 12 June 1999, immediately after the legislation was passed.

Accordingly, the suspension period was from 5 May 1999 to 11 June 1999, a period of five weeks.

Audit Comment

The above observations, in my opinion, give rise to the following issues.

7.2.2 Timing of Contract Suspension

Audit notes that the disposal process was effectively 'on hold' because of the delay in passage of the disposal legislation from December 1998 to June 1999. As acknowledged by the Lead Advisers their workload would decline significantly from mid February 1999.[120] Moreover, the ERSU Minute of 23 December 1998 to the Treasurer[121] recommended that the Government consider terminating or suspending the consultancy contracts in the period up to mid February 1999.

Audit accepts that until mid February 1999 the Government was faced with a very fluid situation in terms of the passage of the disposal legislation. Nevertheless, I consider that there was scope for the Government to negotiate an earlier suspension of the Consultancy Agreement with a commensurate saving in fees. Proactive management of the Consultancy Agreement would have resulted in suspension taking effect upon the rejection of the disposal legislation by Parliament in February 1999 or shortly thereafter.

Audit also notes that the Lead Advisers' Agreement was only formally reactivated by the Government some seven weeks after the disposal legislation passed and then retrospectively for that seven week period. In my opinion, this lack of timeliness represents poor contract administration and management.

Audit Recommendation 29

I recommend that an appropriate contract management system be established for every material contract to ensure variations are negotiated and formalised in a timely manner.

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[119] In a conference between Audit and the ERSU on 6 July 2000.

[120] Lead Adviser Memorandum to ERSU, 'Revised Work Program', dated 11 December 1998.

[121] Minute forming Enclosure to the Treasurer 'ERSU Arrangements from 10 December', dated 22 December 1998.

7.2.3 Re-activation of the Contract

Although the variation to the Legal Advisers' contract was not effected and the terms of the variation were discussed at length, no measures were put in place to deal with the situation of how to reintegrate to the Project, or alternatively terminate, the Legal Advisers in the event that members of the consortium acted for a financier during the suspension period.

Further, the ERSU has advised Audit[122] that it did not undertake any inquiries before reactivating the Accounting Adviser contract to establish whether KPMG had acted for others during the suspension period or whether any conflict of interest had arisen as a result. The ERSU indicated that they considered the contract adequately covered the question of conflict of interest and accordingly relied on those terms.

Clause 16 provides that the Accounting Adviser must disclose in writing any actual or potential conflict as soon as practical after it becomes aware of the conflict. However, in the event the Government received that advice its remedies would be circumscribed as discussed under the heading '6.3 — Contract Terms Dealing with Conflicts of Interest' in this Report. Given the limitations on the Government's ability to terminate the contract for conflict of interest, I am of the opinion that the better course would have been to seek assurances regarding conflict of interest before reactivating the contract.

Audit Recommendation 30

I recommend that where it is proposed to allow consultants to work for others during a period of suspension without government consent, the terms of the suspension must also outline a process for reactivation that provides for assurances as to conflict of interest and allows for termination in the event a potential or actual conflict of interest is identified.

7.3 VARIATION TO AGREEMENT SOUGHT BY LEAD ADVISERS

In mid 1999 the Lead Advisers sought a variation to the contract which would have had the effect of increasing the fees payable over the whole project by approximately $2.5 million.

The basis of the variation was the Lead Advisers' contention that the clear understanding of the parties at the time of entering into the contract in April 1998 was that the disposal program would be completed within 12 months.

> *As things stand we have maintained our commitment of resources, at not inconsiderable cost to ourselves, for a period eight months longer than was intended by the Government and ourselves in March 1998.*[123]

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[122] In a conference between Audit and the ERSU on 6 July 2000.

[123] Letter dated 3 August 1999 from Lead Advisers to the Treasurer.

The Lead Advisers argued that the fee structure had been negotiated on the assumption that the first sale/lease would be completed in early 1999 and that Stages 2 and 3 would overlap (Clause 1.2(g) of the Second Schedule to the contract). In fact there was no overlap to any material extent because the disposal legislation was initially not passed by Parliament and Stage 3 was delayed. As a result of this delay the ultimate receipt of the success fees would be much less than originally anticipated (because the increased duration of the project meant the Lead Advisers would receive more fixed monthly fees and these fixed monthly fees in excess of $2 million are rebateable against the success fees). Accordingly, the Lead Advisers sought a good faith review of the success fees under Clause 1.3 of the Second Schedule to the Consultancy Agreement.[124]

The ERSU put forward an alternative proposal to the Treasurer that would increase the Lead Advisers' fees by $1.4 million.[125] The ERSU rationale for this is:

> *The proposal basically allows [the Lead Adviser] to add to the non-rebatable amount the monthly fees of $1.4 million paid to them during the period December 1998 to June 1999 (at which time the legislation was passed). ERSU believes this recommendation would adjust the fee arrangement in a fair and equitable way to bring it into line with the original assumptions underlying the initial negotiations.*

The proposal was supported by advice from Crown Law dated 4 April 2000. That advice indicated the Treasurer had to negotiate the fee increase in good faith because the assumptions on which the contract was entered had since proven to be incorrect.

The Treasurer approved this proposal on 4 April 2000.

Audit Comment

I agree that, following the Lead Advisers' request for a variation, it was necessary to negotiate in good faith if the underlying assumptions had changed. However, a negotiation in good faith still allows for an assessment as to whether there has been a change in assumptions and whether as a result of that change it is fair and equitable that fees be increased.

In my opinion, there may have been an equitable obligation in the circumstances if the scope of work under the Consultancy Agreement had significantly increased or the clear timeline agreed by the parties had been delayed and the Lead Advisers had suffered financial detriment as a result. With respect to this matter, I have already raised my concerns earlier in this Report that the Consultancy Agreement contains no comprehensive Services Specification and establishes no timelines or milestones for Stages 2 and 3 of the project. Refer to discussion in this Report under the heading '6.2 Definition of Services'.

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[124] This entire paragraph paraphrases from the ERSU Minute to the Treasurer, 'Morgan Stanley/Pacific Road Consultancy Contract — Variation', dated 4 April 2000.

[125] Attachment 2 to Minute to the Treasurer '[Lead Adviser] Success Fee' dated 27 October 1999.

I have difficulty with the Lead Advisers' contention as to the understanding of the parties, as the RFP itself set out a proposed two year timetable for the disposal process. Audit notes that in their proposal the Lead Advisers expressly acknowledged the disposal process would take two years[126] and that the precise timing would depend on the time taken to decide and implement policy.[127] In the latter respect the Lead Advisers would have been cognisant throughout that passage of the disposal legislation was a prerequisite for the disposal to proceed and that passage was not a formality. Consequently, I have difficulty with the rationale for the ERSU conclusion that it was unreasonable for the Lead Advisers to be expected to anticipate the delay in the Parliamentary process. In any event, the Lead Advisers continued to receive fixed monthly fees and allowances throughout the period. However, I note that the Crown Law advice states unequivocally, on the basis of the author's own involvement in contract negotiations, that the Project has taken longer than expected. On this basis it appears that the documentation may not accurately reflect the assumptions on which the decision to enter the contract was based.

Audit Recommendation 31

I recommend that where an agreement is entered into on the basis of assumptions which if later proved incorrect will entitle the contractor to negotiate changed fee arrangements, the assumptions in question must be fully documented so that it is possible to determine whether any fee increase is warranted from an objective review of the documentation.

7.4 MANAGEMENT OF ACTUAL OR POTENTIAL CONFLICT OF INTEREST

A number of conflict of interest issues arose during the performance of these consultancies. The most significant, in my view, are set out below.

7.4.1 Conflict of Interest of a Lead Adviser

The Lead Advisers Consultancy Agreement executed on 15 April 1998 is signed by both Morgan Stanley Australia Limited and Pacific Road Corporate Finance Pty Ltd and provides[128] that the Lead Adviser may not substitute staff without the prior consent of the Treasurer's Representative and that:

> *In the case of any of the individuals [names inserted], the Client's Representative need not assign any reason for refusing to give his consent*

[126] 'We consider that a three-stage process to be completed in 2 years is achievable with strong government support.' Section 2 'The method by which the team proposes to give effect to the Government's reform program', Lead Adviser's Proposal dated 27 February 1998.

[127] ibid, 'Stage 3 — Sale Process', 3. 'The timeframe in which elements of the information gathering, reform, restructuring and sale process can be executed'.

[128] Clause 5.6(b) of the Consultancy Agreement.

because the Treasurer has relied on the availability of those individuals in selecting the Consultant as the lead adviser. In any other case, the Treasurer's Representative may not unreasonably withhold his consent.

Clause 14.7 provides that the Treasurer may terminate the Agreement if the Lead Advisers' staff are not available to the Lead Advisers to perform the services.

On 29 July 1999 one of the persons specifically named in the Agreement with the Lead Advisers as a person whose availability the Treasurer had relied upon disclosed that he had a potential for conflict of interest as he held a directorship with certain companies, which he believed proposed to lodge an expression of interest in anticipation of joining a bidding group. The Treasurer wrote to the person in question on 23 September 1999 advising that due to the potential conflict of interest that person was not to participate as a member of the committee established for the evaluation of Final Bids for ETSA Utilities Pty Ltd and ETSA Power Pty Ltd and was no longer to participate as an adviser in respect of the disposal process.

Audit Comment

The above events, in my opinion, give rise to two issues, namely:

- whether the withdrawal of the individual is sufficient to remove all conflicts of interest;
- whether the State should be entitled to any compensation for the withdrawal of a key member of the Lead Advisers.

The substitution of a person with such an interest by an employee of the same entity does not, in my view, completely remedy any potential for a conflict of interest. This is because the person with such an interest benefits financially as a shareholder from the actions of the employee, and also as a Director, is in a position of influence over that employee.

Although the ERSU sought the advice of Senior Counsel on this matter, I note that the advice was sought by way of putting specific questions to Senior Counsel, with the result that he did not comment on some of the issues I have raised in this Report. For example the advice from Senior Counsel reads in part:

I make no judgment as to whether in the circumstances Mr [...] has a conflict of interest and whether [the Lead Adviser consortium member in question] has become 'infected' as a consequence merely by him being the principal. However it seems to me that the structure of [the Lead Adviser consortium member in question] leads to the conclusion that the consultant entity in so far as it comprises [the Lead Adviser consortium member in question] can be seen to be giving advice in which [the Lead Adviser consortium member in question] is viewed as a whole. It is therefore of concern that Mr [...] is theoretically in a position through his control of the corporate structure to direct and instruct the employees of [the Lead Adviser consortium member in question] who are the staff that [the Lead Adviser consortium member in question] relies upon to carry out its part of the consultancy agreement.

> *The question that I am asked is not predicated on whether or not [the Lead Adviser consortium member in question] has a conflict of interest within the meaning of its agreement with the Government. Accordingly I express no view on this aspect.*[129]

When the person notified the Treasurer of the potential conflict of interest the Treasurer did not raise with the person in question whether his notification was consistent with clause 15 of the Consultancy Agreement, ie 'as soon as practicable after it becomes aware of the existence of a potential or actual conflict of interest'.

Further, there is no documented evidence that the State discussed with the Lead Advisers the impact of the unavailability through conflict of interest of a named key person. Had this been done, it may have been appropriate for the Treasurer to consider taking contractual remedies (eg clause 14.7 'Termination for Staffing Reasons') against the consultant or seeking compensation because of the non availability of a specifically named key person to perform the services specified in the Consultancy Agreement.

Audit Recommendation 32

I recommend that consideration be given to seeking compensation from the Lead Adviser because of the unavailability of key personnel through a conflict of interest.

7.4.2 Hyder Consulting Potential Conflict of Interest

Hyder Consulting commenced providing services to the ERSU on 1 June 1998. Those services included an environmental impact assessment for the Pelican Point power station.[130] Since July 1997 Hyder Consulting had been providing services to Australian Steel Corporation (ASC) in relation to ASC's plans to establish a shipbreaking/steel making facility at Pelican Point.[131] On 10 September 1998 ASC confirmed to the State that it was interested in acquiring the assets of one of the electricity generation businesses Peakco, including an option to construct a new 500 MW power station at Pelican Point. Plans submitted by ASC showing the siting of the new station had been drawn up by Hyder Consulting.[132] On 14 September 1998 the ERSU wrote to Hyder Consulting expressing concern and asking that Hyder Consulting cease providing services to the ASC. It reminded Hyder of its obligations in relation to conflict of interest and confidentiality under the consultancy contract with the State and sought assurances that confidentiality had been maintained.

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129 Memorandum of Advice dated 26 November 1999 from Malcolm Gray QC.

130 Minute Forming Enclosure to the Treasurer from the ERSU dated 30 July 1999.

131 Letter from Hyder Consulting to the ERSU dated 24 September 1998.

132 Letter from the ERSU to Hyder Consulting dated 14 September 1998.

Hyder Consulting responded to the ERSU on 24 September 1998 indicating that there was no conflict or potential conflict of interest about which they could notify the Treasurer, and made the following points:

- Hyder Consulting did not know ASC was submitting a bid.
- The work performed by Hyder Consulting for ASC only related to ASC's plans to establish a shipbreaking/steel making facility.
- The ERSU was aware or should have been aware of the Hyder Consulting's involvement with ASC because of information given to the ERSU by the Department of Industry and Trade.
- It was reasonable for Hyder Consulting to assume that the SA Government had no objection to Hyder Consulting continuing in its role as adviser to ASC while an adviser to the Treasurer.

Nonetheless, Hyder Consulting suspended providing services to ASC on receipt of the letter from the ERSU.

On 13 October 1998 the ERSU wrote to Hyder Consulting accepting its undertaking that it would not perform further work for the ASC. That letter also requested that Hyder decline any invitation to participate in any other project proposed for the Pelican Point land while contracted to the State.

Audit Comment

Although the onus should be on the particular adviser to identify and report on any conflicts of interest (whether they be potential, actual or perceived), there is no documentation to demonstrate that there was disclosure of any conflicts of interest or that they were followed up by the ERSU at the time the advisers were being selected. Such a process of documented enquiry would have been consistent with the approach adopted for the selection of the Lead, Legal and Accounting Advisers.

I note that Hyder Consulting had indicated to the Selection Panel at interview that any potential conflicts of interest could be handled, citing that environmental auditors ascribed to a code of ethics.[133] Audit has not sighted that code of ethics and I am not able to make any comment as to whether Hyder Consulting's actions were consistent with that code.

However, I consider that Hyder Consulting has a valid point that its involvement in ASC's shipbreaking project was known to the Government before it entered into this Consultancy Agreement. Further, a probity or background check by the ERSU at the time of the selection process should have identified Hyder Consulting's relationship with the Australian Steel Corporation. The fact that this relationship was only discovered and raised by the ERSU well over three months after services commenced raises serious accountability and contract management issues.

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[133] ibid.

I note that it took the ERSU three weeks to respond to the letter of 24 September 1998 from Hyder Consulting and then the ERSU simply accepted, at face value, the assurances given by Hyder. Having regard to the seriousness of this 'potential conflict of interest', including its potential to found a legal challenge, I would have expected the Government to have undertaken a more rigorous examination of Hyder Consulting's role in advising the Australian Steel Corporation and taken legal advice (appropriately at Senior Counsel level) on the Government's risk exposure. The ERSU documents perused by Audit do not indicate that these precautionary steps were taken.

In addition, I note that the letter from the ERSU to Hyder Consulting dated 14 September 1998 was copied to the Probity Auditor at that time. With respect to potential conflicts of interest that arose from time to time with other advisers, there is documented evidence of advice from the Probity Auditor or other legal advisers as to the resolution of the conflict, and the impact that it may have had on the disposal process. No such documentation could be sighted with respect to the above conflict of interest.

Audit Recommendation 33

I recommend that the State, as a matter of practice and procedure, conduct detailed probity and background checks against all contractors bidding for significant consultancy contracts which have the potential to give rise to significant liability exposure for the Government.

7.4.3 Sinclair Knight Merz (SKM)

Audit has also sighted the ERSU documentation showing that various technical consultants wished to act for potential bidders. One of these was SKM. In its advisory role SKM had produced a number of reports on generation assets and those reports were released to bidders with the Information Memorandum. SKM indicated that they would not act for bidders should the ERSU request that they not do so.

Audit Comment

It is my view that in proposing to act for bidders SKM was certainly faced with a situation of 'potential material conflict', if not actual conflict. It is also my view that the ERSU acted properly in obtaining professional advice from respectively the Probity Auditor, the Lead Advisers and the Crown Solicitor.

My understanding of the advice from the Probity Auditor is that, if SKM was to be allowed to act for bidders for assets, at the very least, SKM should not continue to work for the ERSU at the same time. The Probity Auditor states that actual conflict of interest could be dealt with by a number of measures, but primarily by terminating the services of SKM.[134]

[134] Advice from Probity Auditor to the ERSU dated 27 July 1999.

The Probity Auditor also deals with a perception of conflict and it is in that context that he suggests that disinterested industry advice be obtained to see whether it would be likely that a bidder in the industry would not be concerned if SKM acted for other bidders on the basis that Chinese walls would be in place. Again, that is on the basis that 'then SKM could be terminated by ERSU and then allowed to act for bidders'.

Similarly, the Lead Advisers advise that SKM should be allowed to act for bidders, 'once they have completed their role with Government' and that 'SKM's role would terminate with the Government with the release of its reports at the end of August [1999]'.[135]

Even so, the ERSU expressly sought to retain 'the current SKM personnel' as well as allow SKM to act for bidders.[136] Despite the recommendation that the existing Consultancy Agreement be amended to reflect the conditions set out in the ERSU minute to the Treasurer of 30 July 1999, the Consultancy Agreement was not so amended.

In response to the Probity Auditor's recommendation that disinterested industry advice be sought, the ERSU obtained advice from the Lead Advisers,[137] I am concerned that the Lead Adviser could not in fact fulfil that role. The Lead Advisers (Morgan Stanely/Pacific Road) are not in the 'industry' or business of electricity generation or in the business of purchasing and operating generation assets.

I note the conditions on which SKM was permitted by the Treasurer to act for bidders and I am not suggesting that SKM in advising bidders deviated in any way from these conditions. However, I am concerned that notwithstanding these safeguards the potential for a perception of a conflict of interest arising remains. I note that this risk would not have arisen if the ERSU had accepted SKM's offer that they would not act for bidders should the ERSU request that they not do so (a point also made by the Probity Auditor).

It is noted that no concerns have been raised by bidders in relation to the role played by SKM. I also note that the ERSU has expressed its opinion that advice from the Lead Advisers did represent disinterested industry advice. On this point I am of a different opinion.

Audit Recommendation 34

I recommend that where a Probity Auditor is employed in disposal processes the State should strictly comply with any course of action recommended by the Probity Auditor to deal with conflict of interest issues. Any decision to deviate from a course of action recommended by the Probity Auditor must be fully documented. Such documentation must include a written record of any other professional advice on which the State based its decision to deviate.

135 Advice from Lead Advisers to the ERSU dated 19 July 1999.

136 Letter from the ERSU to Audit dated 21 July 2000.

137 Minute Forming Enclosure to the Treasurer from the ERSU dated 30 July 1999.

7.5 CONTRACT MANAGEMENT SYSTEM

'It is important that consultancies are managed effectively to ensure that required outcomes are achieved at minimum cost'.[138] The need for proper and effective contract management is self evident — its absence could create financial and liability risks for the State. In this respect it must be remembered that it is the Consultancy Agreement which is the operative document that formally defines and governs the relationship between the parties. Proper contract management includes ensuring adherence to terms and conditions of the contract, monitoring work progress against the approved plan and appropriate internal controls to ensure that the consultancy in general, and risks in particular, are managed effectively.[139]

The ERSU have provided a number of responses to Audit's questions as to the nature of their contract management system for the Adviser contracts. Initially, the ERSU's description of their contract management system dealt only with the receipt and payment of invoices.[140] Later the ERSU indicated a more elaborate contract management system was in place which provided for a Senior Adviser Group that met weekly to monitor the performance and progress of the Advisers.[141]

Audit Comment

In my opinion, despite the description provided by the ERSU as to the process by which the contracts are managed, the issues raised in this Report demonstrate that an adequate contract management system has not been in place whereby performance by the Advisers can be monitored against the terms of the Agreement and issues arising are dealt with within the terms of the Agreement.

In particular I have identified in this Report[142] circumstances where enforcing the application of the terms of the Consultancy Agreement or pro-active contract administration and management could have positively impacted on the costs of the Advisers to the Government. As a result, I am of the opinion that those dealing with the Advisers on a day to day basis are either not sufficiently acquainted with the terms of the contracts to enforce them, or choose to waive the State's rights under the Agreement.

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138 Department of Treasury and Finance Guidelines for the Use of Consultants/Contractors, Section 8 'General Administration and Reporting'.

139 Department of Treasury and Finance Guidelines for the Use of Consultants/Contractors, Appendix 6 'Contract Administrative Management Procedures'.

140 Letter dated 19 June 2000 from the ERSU to Audit.

141 Letter dated 31 August 2000 from the Under Treasurer covering the ERSU response to issues raised by Audit.

142 Refer to commentary in this Report under the heading '6.2 — Definition of Services, '7.2 — Suspension of the Contract', '7.3 — Variation to Agreement Sought by Lead Advisers' and '7.4 — Management of Actual or Potential Conflict of Interest'.

I consider the ERSU should have had a management system in place whereby the performance of the Advisers was monitored throughout against the terms of their Consultancy Agreements. Further, I consider that regular (perhaps monthly) formal reviews of the performance of the Advisers as against the terms of their Consultancy Agreements should have taken place and been appropriately documented.

Proper contract management is not confined to ensuring that performance is monitored against the terms of the contract but also involves being pro-active in negotiations to ensure that any variations to the Consultancy Agreement which are potentially of benefit to the State are pursued in a timely fashion.

Audit Recommendation 35

I recommend that an appropriate contract management system be established for material consultancies, and that such a system include regular formal reviews of the performance of the consultant as against the key terms of the contract.

APPENDIX A

A BRIEF DISCUSSION ON INDEMNITIES

An indemnity is effectively a legally binding promise whereby one party undertakes to accept the risk of loss or damage another may suffer. Each indemnity provided by the issuing party obligates it to protect another party against the consequences of the risks specified in the indemnity. In effect, the recipient of the indemnity is exempted from the possibility of incurring particular losses or liabilities which, if they ever arise, are assumed by the issuing party.

Indemnities can form separate contracts (whether or not in the form of a separate deed) or they can be contained within a contract as a clause or set of clauses.

Essentially, indemnities will cover the following types of risk under a contract:

- potential losses or damages for which the issuing party may otherwise be liable (at law) although the initial loss may accrue to the other party;
- potential losses or damages for which the issuing party, without having issued an indemnity, would not otherwise be liable.

In the first category, for example, an issuing party purchasing a good or service from a contractor (such as an adviser) may indemnify the contractor against some loss suffered as a result of the issuing party's negligence or breach of contract. Equally, a contractor in providing goods or services to a client may indemnify that client against possible losses arising from legal action by a third party, injured or otherwise disaffected as a result of the contractor's actions (such as negligently providing defective equipment to the client).

Indemnities in the second category are generally issued to cover potential losses for which the issuing party would otherwise be blameless. For example, a contractor may indemnify a client for any loss or damage it suffers as long as that loss or damage was not caused by the unlawful or negligent acts or omissions of the client. This type of indemnity effectively makes the contractor responsible for loss or damage caused by other parties, such as a subcontractor.

Indemnities can, therefore, cover both acts or omissions for which the issuing party is legally responsible, and loss or damage resulting from the behaviour of other parties. Indemnities can be silent on the quantum of liability that may accrue if an event specified in the indemnity occurs, or they may be limited to a set amount (eg the contract price). Indemnities can also be drafted to exclude liability for certain types of loss, for example economic loss or consequential damages.

DAMAGES UNDER CONTRACT

Damages for breach of contract are awarded essentially to compensate a party for loss caused by the breach. Non-compensatory damages, such as punitive or exemplary damages are not generally awarded for breach of contract.

Damages for loss are only awarded if a breach of contract is proved and:

- a loss has occurred;
- the loss was caused by the breach (principle of causation);
- the loss was reasonably foreseeable (principle of remoteness);
- the loss could not have been prevented by the reasonable effort of the claimant (principle of mitigation).

BENEFITS OF INCLUDING INDEMNITIES

The above criteria, together with the need to demonstrate that the other party has breached the conditions of the contract, effectively place parameters around the compensation available to an injured party. While a breach of contract will invariably raise the issue of a possible damages claim by the injured, a right to claim damages is not adversely affected by the inclusion of particular indemnities in the contract itself.

There are a number benefits in expressly dealing with certain types of loss or damage (eg personal injury, death, damage to property) through contractual indemnities including:

- that the party indemnified is in the position of having to prove and claim against specific sets of events rather than relying on demonstrating that the other party has defaulted under one or more of the conditions of the contract;
- that the issuing party has, in effect, agreed to accept liability for the occurrence of specified events provided that those events can be proved to have occurred;
- the party indemnified may have the benefit of an indemnity which not only covers fault on the part of the other party, but also any loss or damage not caused by the indemnified party's own unlawful or negligent acts or omissions;
- the party indemnified is financially covered (subject to any agreed financial limits) for loss or damage addressed by the indemnity (including possible loss or damage to third parties).