

Ai GROUP DEFENCE COUNCIL

Submission to National Commission of Audit - Defence

Introduction

The Ai Group Defence Council (referred to hereon as the DC) welcomes the opportunity to offer a submission to the National Commission of Audit (referred to hereon as the NCA) on waste in Defence, including options for improving procurement within the portfolio.

Joe Hockey and Mathias Cormann, when announcing creation of the NCA, led by Tony Shepherd, a former member of the Ai Group Defence Council, noted that the audit will provide an opportunity to have a “root and branch” examination of Defence’s budgetary arrangements.

Robert Caro, in his Pulitzer Prize-winning biography *The Power Broker* describes the Machiavellian Robert Moses of New York infamy in the following terms:

“In a remarkably brief time after Moses entered the city administration, word had spread through City Hall and the Municipal Building that any time someone got in Mose’s way, Moses kicked them in the balls...The great spongy mass of the city’s bureaucracy, a mass of inertia and red tape and obfuscation and confusion, had absorbed and smothered the energy and dreams of a thousand Commissioners – but Commissioner Moses sliced through the bureaucracy as if it were soft butter and he were a knife.”

The Ai Group Defence Council, whilst committed to reform within Defence resulting from the work of the NCA, nonetheless believes that a measured approach is appropriate in making

essential changes across the Defence portfolio, especially within the Defence procurement system administered by the Defence Materiel Organisation (DMO).

Members of the Ai Group Defence Council National Executive, which includes the Chief Executive Officers of defence companies large and small, have offered their views for inclusion in this submission.

This paper offers a snapshot of their views and a number of recommendations to improve the efficiency and effectiveness of the Defence procurement system. Also **attached** are two examples of submissions from Defence Council members expressing their views and recommendations.

Coalition Defence Policy

Prior to the Federal Election, the Coalition announced that it would strengthen Australia's defence capabilities, stop the under-investment in Defence, ensure no further cuts to Defence spending and increase, over the next decade, the current level of Defence spending from 1.59 per cent of GDP – the lowest level since 1938 – to two per cent of GDP.

By contrast, the former Labor Government cut \$5.4 billion from Defence spending in the 2012 Federal Budget, causing the abandonment of a number of new equipment projects, such as the self-propelled howitzer, and delays to a number of other priority equipment acquisitions.

According to Senator David Johnston, in a speech to a recent Australian Strategic Policy Institute and Boeing Australia dinner, in Canberra, said that “The past five years have been nothing less than a series of significant financial setbacks for Defence.” He reported that, since 2009, more than \$16 billion in Defence spending has either been cut or deferred, resulting in 122 projects being delayed by up to four years. He added that

“the Strategic Reform Program was developed with a lot of effort...It was a significant piece of high-quality work that sadly was disregarded as quickly as it was written. The planned \$20.6 billion of savings that were to be ploughed back into Defence never materialised.”

The contrast between the Coalition’s approach to Defence policy and that of the previous government is stark.

The Abbott Government has sent a strong signal that ‘a changing of the guard’ offers a higher degree of certainty for defence industry. This will underpin future decisions by companies planning to invest in Defence tendering and contracting arrangements.

A number of other pre-election policy announcements by the Coalition are being watched with considerable interest within the defence industry sector. This includes the undertaking to have a first-principles review of the Defence department’s structure and its major processes.

Reducing Waste and Inefficiency in Defence

The Coalition Government’s policy is to reduce waste and duplication across government agencies and departments, including Defence.

The recent withdrawal of ADF personnel from Afghanistan by Christmas 2013 offers scope to re-examine the future role of the ADF. One opportunity arising from this change is to examine the top-heavy bureaucracy in Defence. For example, for many years resulting from the Tange Review of Defence three Deputy Secretaries were responsible for managing and administering key elements of the department. Now, however, there are some 16 Deputy Secretary equivalents in Defence, which is excessive and unnecessary. This situation should be reviewed by the NCA.

Reform of the Defence Materiel Organisation (DMO) and a strengthening of its relationship with Australian businesses is another positive Coalition policy, one advocated by the AiGroup Defence Council National Executive in recent years.

The DMO is responsible for equipment procurement and sustainment for the Australian Defence Force (ADF).

More than 7,000 people are employed in the DMO, up from around 2,500 over a decade ago.

The scale and number of equipment acquisitions has not changed significantly during that period, although auditor and parliamentary scrutiny has increased, leading to a case for some increase in staffing. However, a more than 100 per cent increase in staffing cannot be justified.

DMO's annual budget amounts to nearly \$10 billion. Of this, some \$4 billion is allocated to new equipment acquisition, \$5 billion to sustainment and more than \$800 million to administration.

The latter expenditure supports, among other things, a large number of Special Project Offices (SPOs), many of which appear to duplicate work practices and staffing within the DMO. The NCA would do well to examine the plethora of SPOs, with an eye to rationalising the number and scope of their work.

Role of the DMO

The DMO's principal roles are to buy equipment for the ADF and to contract out sustainment of ADF equipment. However, increasingly, the DMO has sought to be a project manager. The Air Warfare Destroyer is a current example of the DMO undertaking this latter role, one for which it is ill qualified to perform. It has neither the in-house engineering, risk management and commercial expertise required for project

managing complex equipment acquisition projects. Its key role should revert to being the Commonwealth's buyer of equipment and services. Project management should reside with commercial contractors, usually Prime Defence Contractors for complex, high risk equipment acquisition projects. It is these companies which have the ongoing experience for undertaking such tasks.

There is a tendency with Defence to send staff to conferences and courses to seek to become project manager experts. Commercial companies, on the other hand, build up the expertise of project managers – usually engineers – over many years as they project manage less complex then more complex projects, eventually worth billions of dollars. Attendance at course, whilst helpful, do not provide the 'hands on' experience that many years of project sweat offer, usually leading to successful project outcomes. The DMO should refrain from such a strategy, which is contrary to its principal roles.

Defence Procurement Tendering and Contracting

DC members have long believed that the Defence procurement system is too complex, too time-consuming and too costly.

The DMO has maintained a strong reliance on competitive tendering for the selection of services, equipment and suppliers. Whilst this approach generally achieves a sound outcome if the tender selection criteria are valid and rigorously applied, the DMO does not measure and respond to the broader cost implications of this competitive approach, particularly when simpler, more flexible and cheaper purchasing strategies could achieve the same outcome.

Current practices within Defence which unduly inflate the overall costs of tendering are:

- Calling for tenders when there is a compelling case for a particular product or supplier;

- Requests for Tender that are not essential to the bid selection process;
- Requests for excessive levels of detail in Tender Deliverables;
- Failure to pre-qualify tenderers based on core capability, in order to reduce nugatory tender expense; and
- Excessive tender evaluation periods, which are in part driven by the number and size of tender responses solicited. In addition to increasing the Defence resources involved in tender evaluation, this increased timescale pushes up contractor tender response support costs.

The essential issue is that all tendering costs are ultimately borne by the customer (the Australian Government). Contractors must fund their bidding costs via overheads levied on the goods and services that they provide. Excessive bid costs and the costs of unsuccessful bids just push these overhead costs higher.

Intellectual Property

Some DMO tenders and associated briefings indicate that the Commonwealth reserves the right to use Intellectual Property (IP) provided in unsuccessful tender proposals, or that the extent to which tenderers propose transfer of IP rights to the Commonwealth will be used as a tender evaluation criteria.

Both practices discourage the incorporation of innovative solutions or tenderer background IP into tenders for far that rights to this IP are being handed over to the Commonwealth (or potential competitors) without compensation as a result of the tendering process.

Timeframes to Enter Contract

Over many years, many Ai Group Defence Council member companies have complained about the time it takes to get to contract. It's not unusual for such negotiations to take between

more than 24 months. This lengthy duration introduces many risks both to the cost basis of individual proposals and the ability of companies to maintain the resource base necessary to execute the task when the contract is finally awarded. These uncertainties are cost drivers within the proposals submitted to the Commonwealth. This can result in either reduced Value-for-Money and/or increase risk to the successful outcomes of programs.

Ownership and Transfer of Risk

Standard ASDEFCON terms transfer much of a program's risk to the contractor, often when they are not best placed to manage or mitigate the risk. This often results in cost implications as the contractor ties to develop strategies to accept and manage the risk, such as project-specific processes, additional resource or specialised insurance policies.

Ability of the DMO to Effectively Evaluate Value-for-Money

Whilst Commonwealth Procurement Rules establish Value-for-Money as the core principle governing Commonwealth procurement, Ai Group member companies believe that this is proving difficult to achieve in practice. Tender evaluations place a disproportionate weighting on the dollar value figure over other aspects of the bid that reduce risk and hence offer a higher probability of success in achieving the government's desired outcomes. It is relatively easy to determine 'value-for-money' with a direct dollar comparison, but much harder when considering other non-financial aspects of the bid.

Security Clearances

Complex Defence capability acquisitions require specialist knowledge to be applied to re-risk the programs and ensure success. On occasions, Ai Group Defence Council companies are unable to source the required skills and experience from the

local market whilst doing so off-shore. The current Government security clearance requirements for non-Australian citizens often prevent the hiring and utilisation of these valuable resources that could help deliver new capability to the ADF. It's not unusual for such security clearances to take more than 6 months. One option available to the Commonwealth is a Citizens Waiver, which is available on some projects but it cannot be transferred to another project. This is an unnecessary impediment to companies seeking to prosecute multiple projects successfully.

DMOSS Panel Operations and Terms

The DMOSS Standing Offer was established to engage industry in an efficient way on a Time & Materials (T&M) basis and the Deed's terms and conditions were designed to support this. The DMOSS Deed is now being used to support Fixed Price contracting. This has presented some challenges in achieving Value-for-Money for the Commonwealth.

It's the case that Acquisition Projects are a dynamic activity and fixed scopes of work are very hard to define – additional cost is required to cater for risk which may not always represent Value-for-Money.

The DMOSS Deed does not have ant Excusable Delay Clauses to cater for the dynamic environment in which fixed-price contracts are being executed. This may require companies to include additional schedule contingency in order to cater for risk and may not, therefore, result in Value-for-Money outcomes.

The Standing Offer quotation template still requires a daily rate to be provided for identified skill sets. This has no relevance to fixed-price tasks and often leads to protracted clarifications as the Commonwealth attempts to correlate a T7M rate with a Fixed Price Offer. There is often little understanding of the management or risk profiles of undertaking a fixed-price project over a T&M task. This has led to inefficiency in engagement,

with protracted negotiations, or evaluations being based on incorrect assumptions with no clarifications being sought.

Some Ai Group Defence Council member companies believe that this who joined the DMOSS Panel originally are now at a price disadvantage compared with members who have joined more recently. Under the Deed, rates are escalated annually in accordance with an escalation formula; however industry members who have joined later have been able to secure rates higher than the escalated rates of earlier members. This has created an uneven playing field which is inconsistent with the spirit of the Deed.

Recommendations

The following recommendations are proposed:

- Review the top-heavy bureaucracy with Defence;
- Redefine the role of the DMO giving it full responsibility as the byer of equipment and sustainment services whilst abolishing its project management activities;
- Reduce the over-staffing within the DMO, perhaps by half;
- Consider handing sustainment back to the single Service Chiefs;
- Reduce reliance on competitive tendering and apply cheaper and more flexible acquisition methodologies where appropriate (such as capability-based selection and partnering);
- Develop metrics to assess the total cost of tendering (both government and tenderer expenditures) and make the reduction of these costs one of the KPIs of DMO acquisition teams;
- Increased recognition and protection of IP incorporated into tender submissions by tenderers and assurances that:
 - IP provided in tenders will be acknowledged as background IP as it has been funded by tenderers and

provided prior to entering contract with the Commonwealth; and

- IP provided in unsuccessful tenders will either be destroyed or returned to the tenderer, and will not be used by the DMO in the delivery of the products or services to government, and will not be revealed to the successful tenderer or other parties.
- In addition to risk management elements already contained within the DPPM, the concept of risk ownership based on most effective and economic management should be introduced;
- Allow contractors that are DISP members to sponsor citizenship waivers;
- Allow DMOSS to sponsor citizenship waivers for Panel major Service Providers;
- Allow fast-tracked clearances for personnel with active security clearances from Five-Eyes countries;
- Undertake a detailed review of DMOSS Deed terms and conditions to effectively support Fixed-Price Contracting;
- Have an annual review of rates to ensure equity between members of the DMOSS panel
- Have DMO hold early, constructive industry briefings, ones which identify potential problems not just scripted messages;
- Utilise Expression of Interest (EOI) phases allowing early identification of underlying issues leading to more effective acquisitions ;
- Encourage DMOSS members to offer innovative solutions; and
- Introduce other procurement strategies which encourage better Value-for-Money outcomes.

Attachments:

A – Submission from Ai Group Defence Council member company

B – Submission from Ai Group Defence Council member company